Alternative Market Mechanisms

For the

Student Loan Program

A Report by the U.S. Department of Education and the U.S. General Accounting Office

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Abbreviations

AGI	Adjusted Gross Income
CBO	Congressional Budget Office
CP	Commercial Paper
DCS	Debt Collection Service
EPA	Environmental Protection Agency
FAFSA	Free Application for Federal Student Aid
FCC	Federal Communications Commission
FDLP	William D. Ford Federal Direct Loan Program
FFELP	Federal Family Education Loan Program
FHA	Federal Housing Authority
GSE	Government Sponsored Enterprise
HEA	Higher Education Act of 1965
HEAL	Health Education Assistance Loan
HHS	Department of Health and Human Services
ICR	Income Contingent Repayment
IDEA	Income Dependent Education Assistance

IRS	Internal Revenue Service
OMB	Office of Management and Budget
PLUS	Parent Loan for Undergraduate Students
SAP	Special Allowance Payment

OVERVIEW

In the Federal Family Education Loan Program (FFELP), lenders annually make over $22 billion in loans to eligible student borrowers who attend postsecondary education institutions and their parents. Additionally, through the William D. Ford Federal Direct Loan Program (FDLP), the federal government makes over $11 billion available to these borrowers. The federal government insures FFELP loans against default[1] and assures lenders of a specified yield, which varies with market interest rates. In obtaining their loans, borrowers agree to pay interest at a rate up to a maximum rate established by law. The federal government pays a "special allowance" to lenders—the difference between the borrower's rate and the specified yield-when the borrower's rate is lower. The Congress occasionally adjusts both the borrower's rate and the lender yield.

In setting lender yield, the Congress attempts to ensure a yield high enough to maintain lender participation in the program but not so high as to require spending more taxpayer dollars than necessary. While the Congress considers information from Education, other federal agencies, and program participants in setting the lender yield, it often lacks credible information on the costs to lenders of making and servicing loans. The Congress determines the lender yields without sufficient information on the underlying costs, and the government does not benefit from any cost-saving improvements in the industry. Thus, setting lender yield is difficult, as illustrated by the extensive deliberations surrounding the 1998 reauthorization of the HEA.

When the Congress considered the reauthorization of the Higher Education Act of 1965 (HEA) in early 1998, both House and Senate committees expressed concern about the process of setting lender yield. In its committee report, the House Committee on Education and the Workforce stated:

> "Currently, the Federal Family Education Loan (FFEL) program is a market-based program with private sector participation. However, to a large extent lender returns are set through a political process rather than a market process. This is disturbing for two reasons. First, if lender yield is set too low, private capital will become unavailable, and the student loan programs will collapse. Second, if the rate of return is set too high, the Federal Government forgoes savings that could be put to better uses or returned to the taxpayer."[2]

The report of the Senate Committee on Labor and Human Resources expressed similar concerns when it stated that the committee "has wrestled with its desire to balance the twin objectives of

[1] FFELP loans are guaranteed by one of 36 nonprofit agencies designated by the Secretary of Education. If a loan goes into default, the guaranty agency generally pays the lender 98 percent of principal and accrued interest. The federal government then generally reinsures 95 percent of the guaranty agencies' payments to lenders (and also pays them fees for loan processing and issuance, account maintenance, and default aversion).

[2] House Report 105-481, 105th Congress, 2d Session, pp. 154-155 (1998).

reducing the interest rate paid by borrowers and preserving access to loans under the FFEL program."[3]

The 1998 amendments to HEA required that GAO and Education jointly convene a study group to analyze whether and how a market mechanism might be introduced to determine lender yield rather than the Congress setting the yield. See appendix I for the full text of the mandate. This study group consisted of representatives of the Department of the Treasury, the Office of Management and Budget (OMB), the Congressional Budget Office (CBO), entities making FFELP loans, other entities in the financial services community, other participants in the student loan programs, and other individuals designated by GAO and Education. See appendix II for a list of study group members. GAO and Education, in consultation with the study group, were charged with identifying at least three different potential market mechanisms and evaluating them with respect to 13 criteria laid out in the mandate.

This draft report, prepared by GAO and Education for public comment, analyzes several models based on research and analysis, discussions with study group members, and comments received from others not on the study group. Serving on the study group does not constitute agreement either in whole or in part with the proposed models or the analysis of models presented in this report. Some study group members may provide additional or dissenting views, which will appear here as appendices.

BACKGROUND AND METHODOLOGY

Lenders in FFELP make loans to student and parent borrowers and receive a yield - an interest rate on the loans - that is set by legislation. Borrowers choose a lender, typically from a list their schools maintain. A guaranty agency reviews the loan application and issues a guarantee on the loan. As long as the loan is serviced properly, the guarantee is maintained, and the guaranty agency repays the lender if the borrower defaults on the loan. Education oversees lender, school, and guaranty agency participation in the program and reimburses the guaranty agencies for default payments provided to lenders. In addition, Education makes payments to lenders to make up the difference, if any, between the interest rate the borrower pays and the yield the lender is entitled to receive.

The yield that lenders receive from FFELP loans has been adjusted occasionally since 1977.[4] For Stafford loans and their predecessors, the Congress set lender yield generally at the 91-day Treasury bill (T-bill) rate plus a markup of 3.5 percentage points in 1977. The Congress made downward changes in the markup over the Treasury bill rate in 1986 and 1992. In 1995, different rates for loans in different stages were established, so that the markup was reduced for loans that were in school, grace, or deferment periods relative to the markup for loans in repayment. Both markups were reduced further in 1998. Finally, in 1999, the Congress changed

[3] Senate Report 105-181, 105th Congress, 2d Session, p. 53 (1998).

[4] Before 1977, a committee composed of the Secretary of Health, Education, and Welfare, the Secretary of the Treasury, and the Director of OMB decided the level at which lender yield should be set. Since 1977, the yield has been established by using a formula set in legislation rather than by a committee's determination, and the Congress adjusts this formula periodically.

the basis for the yield from the 91-day Treasury bill to the 3-month Commercial Paper (CP) index, resulting in an upward change.[5]

In making these changes, the Congress has generally tried to set a yield that would preserve lender interest in the program without spending federal funds excessively. Lenders require a reasonable return on their investment in the program to continue to take part in it. Without a reasonable return, they would be likely to devote their resources to more profitable investments, jeopardizing the continued availability of loan capital for FFELP. However, if the yield is set too high, federal funds could be wasted, because federal dollars are spent to make up the difference between the subsidized rate that the borrower pays and the yield that the lender receives. The Congress has little information on lender costs and profitability to use in setting the lender yield.

In order to explore ways of bringing market information to bear on the yield-setting process, the Congress, in the 1998 HEA reauthorization, mandated a study of the potential use of market mechanisms in FFELP. The mandate calls for evaluating at least three different market mechanisms relative to 13 criteria. We grouped the evaluation criteria into four sets, as shown in table 1.

[5] The lender's yield is the face value of the interest rate on the FFELP loan. Currently, this is set in legislation at the Commercial Paper rate plus 2.34 percentage points for loans in repayment. It is the lender's total interest revenues as a percentage of the value of the loans. A lender's net yield is the lender's yield less all costs, which include the costs of (1) raising funds to make the loans, (2) servicing the loans, (3) defaults, and (4) other administrative expenses. Loan servicing functions include maintaining contact with borrowers, billing for repayments, and taking steps to avoid defaults if loans become delinquent.

Table 1: The Four Sets of Evaluation Criteria

Set	Related criteria from the 1998 HEA amendments
Description of model, including variations	• A description of how the mechanism will be administered and operated (12) • The proposed federal and state role in the operation of the mechanism (11) • Transition procedures (13)[a]
Costs, savings, and effects on subsidies for program participants	• The cost or savings of loans to or for borrowers, including parent borrowers (1) • The cost or savings of the mechanism to the federal government (2) • The cost, effect, and distribution of federal subsidies to or for participants in the program (3)
Effects on lender participation, loan availability, and quality of service	• The effect on the diversity of lenders, including community-based lenders, originating and secondary market lenders (7) • The availability of loans to students by region, income level, and by categories of institutions (10) • The effect on loan availability during a transition period (13)[a] • The effect on investment in human capital and resources, loan servicing capability, and the quality of service to the borrower (6) • The degree to which the mechanism will provide market incentives to encourage continuous improvement in the delivery and servicing of loans (9)
Simplicity, regulatory burden, and program integrity	• The effect on the simplicity of the program, including the effect of the plan on the regulatory burden on students, institutions, lenders, and other program participants (5) • The effect on program integrity (8)

Note: The numbers in parentheses refer to the number assigned to the specific criteria in the legislative mandate. The analysis related to the fourth criterion - the ability of the mechanism to accommodate the potential distribution of subsidies to students through an income-contingent repayment (ICR) option-was similar across all models. Rather than repeat our analysis of this criterion for each model, we discuss it separately in chapter 7. Therefore, this criterion does not appear in this table.

[a] We split the thirteenth criterion, on transition procedures, into a descriptive part and a part related to loan-availability issues.

THE FIVE MODELS

To identify different market mechanisms for analysis, we reviewed reports and asked study group members and others to submit proposals. We looked primarily for models in which some type of market process either determines the lender yield or provides information used to set the yield.

We grouped the proposals into five general models because similar characteristics emerged among some of the proposals. In study group meetings and other conversations with group members, including those with staff from the other government agencies, we discussed the various models and their implications. We also researched comparable programs where they existed, such as other federal auctions and the experiences of student loan programs in other countries.

The five models would make a variety of changes to FFELP.

- The first of the five models we identified-adjustments to the current system - would involve the least change from the current FFELP. Information would be collected from current market transactions for use in determining the appropriate level of lender yield, which the Congress or some independent entity would still set through statute or regulation.
- The loan origination rights auction model would involve lenders bidding for the right to originate loans (either for the right to procure a certain volume, with which they could originate loans at any school, or for the right to originate loans at particular schools). A lender's bid might consist of a specific yield level, so the yield would be directly determined by this mechanism. Alternatively, the bid might consist of a dollar amount for the right to originate loans, with the lender's yield on these loans set outside the process.
- In the loan sale model, in contrast, the government or a government-designated entity[6] would originate loans. Private lenders would then bid in an auction to purchase these loans after they have been originated. Again, the lender yield would be set outside the process, and lenders' bids to purchase these loans would determine their net yield.
- In the federal funding model, lenders would have the opportunity to borrow funds from the federal government to make FFELP loans. They would borrow either at a predetermined interest rate or at an interest rate determined by some type of bidding process. The lender's yield would still be set by the Congress, but by changing lenders' funding costs, this model would determine the net yield for lenders.
- Finally, in the market-set rate model, lenders and borrowers would negotiate their own interest rates and perhaps other loan terms. Regulatory limits, such as a limit on the range of interest rates a lender would be allowed to offer, could be imposed. This process would set both the lender yield and the borrower interest rate.

Table 2 shows some of the major differences between the models, although most of the models have several variations that would allow for further differentiation.

[6] Schools could potentially originate loans as is currently the practice in FDLP.

Table 2: General Differences Between the Five Models

Question to differentiate the models	Adjustments to the current system	Market mechanism model			
		Loan origination rights auction	Loan sale	Federal funding	Market-set rate
How does the model work?	Market information would be used by the Congress or its designee to set lender yield	Lenders would bid for the right to make (1) a certain volume of FFELP loans, or (2) Loans at specific schools	Lenders would bid to purchase loans after the government or some designated entity originated the loans	Lenders would be allowed to borrow funds from the government to make FFELP loans	Lenders and borrowers, or schools on the borrowers' behalf, would negotiate interest rates
What rates or costs does the market determine?	Rates or costs are determined only indirectly based on market information	Either version above could determine (1) the lender's yield or (2) lender's cost to receive a given yield	Lender's cost to acquire the loan and assure a given yield	Lender's funding cost	Lender's yield and borrower's interest rate
Who originates loans?	Private lenders	Private lenders	Federal government, through contractor or other entity	Private lenders	Private lenders
Are private lenders restricted in how much, or at which schools, they originate?	No	Yes, in some cases	Not relevant	No	Unclear
Is the borrower's rate or ability to choose the lender changed?	No	Yes, for lender choice	Yes, for lender choice	No	Yes, for both rates and choice of lender
How does the role of schools change?	No change	Schools may lose choice of lenders	Schools may serve as the originator of the loan	No change	Schools would play a stronger role in determining which lenders to use

THE STRUCTURE OF THIS REPORT

Chapter 1 of this report includes background material, a brief history of FFELP, and a description of the study group's work. Chapters 2 through 6 contain the analysis of each of the five models, relative to the 13 criteria set out in the mandate. Chapter 7 then discusses ICR as it might be applied to any of the models.

CHAPTER 1
PROGRAM BACKGROUND AND 1998 HEA MANDATE

FFELP, established by the HEA, as amended, provides more than $22 billion of loans annually to students pursuing a postsecondary education and their parents. Lenders make loans to eligible borrowers, and the federal government guarantees the loans against default. Borrowers attending schools that participate in FFELP are free to choose their own lender but many schools provide a list of preferred lenders. Borrowers receive loans with differing levels of subsidies, which are based on financial need and length of time in school. The federal government ensures that lenders receive a certain yield, currently based on a CP interest rate, on FFELP loans. The federal government pays lenders the difference between the borrower's interest rate and the lender yield. The Congress adjusts this yield occasionally, but because perfect information on lenders' costs and profitability is not available, the Congress cannot be sure a particular yield is high enough to ensure lender participation but not so high as to spend excessive taxpayer dollars on FFELP. To help the Congress consider adjustments to this yield, the Congress mandated that GAO and Education form a study group to analyze ways in which lender yield in FFELP could be set through a market mechanism rather than through legislation. In accordance with the 1998 amendments to HEA, each mechanism was to be evaluated relative to 13 criteria set out in the mandate. The study group considered a number of proposals, and GAO and Education conducted an analysis of five models that involve market processes to different extents.

HOW THE FEDERAL LOAN PROGRAMS OPERATE

HEA has created two major federal loan programs for students pursuing postsecondary education.[7] In 1965, the original HEA established the guaranteed student loan program (subsequently renamed FFELP), in which loans are originated by lenders, guaranteed by state-chartered guaranty agencies, and reinsured by the federal government. In 1993, HEA authorized FDLP, a second major loan program, in which the federal government provides loan capital, schools originate loans directly to students, and private contractors perform loan origination and servicing functions.

Types of Loans

FFELP and FDLP both include four major types of loans: subsidized Stafford, unsubsidized Stafford, PLUS[8], and consolidation loans.[9] Student borrowers receive subsidized and

[7] HEA also authorized the Perkins Loan program, a relatively small loan program that provides funds to postsecondary institutions that are used to establish a revolving fund from which loans to students are made. The Perkins Loan program-previously known as National Defense and National Direct Student Loan programs-pre-dates HEA by 7 years.

[8] Originally, "PLUS" was an acronym for the official name of the loan program, "Parent Loans for Undergraduate Students." Under current law, the official name of the program is simply "PLUS."

[9] Formula interest rates charged to students under FDLP were set in law generally equal to the formula maximum rates on corresponding FFELP loans.

unsubsidized Stafford loans. Parent borrowers receive PLUS loans. Borrowers may take out consolidation loans before or after entering their repayment period.

Subsidized Stafford Loans

A needs-based subsidized Stafford loan is available to eligible students at participating institutions. The guaranteed amount of a subsidized loan may not exceed the student's "unmet financial need."[10] The maximum loan amount is also subject to annual and aggregate loan limits.

A key feature of the subsidized Stafford loan is its interest subsidy while the student is not in repayment. The government pays, on the borrower's behalf, all interest accruing on the outstanding principal while the borrower is attending school at least half-time, for 6 months after attendance (the "grace period"), and for periods of authorized deferment. Stafford borrowers participating in the standard repayment plan have a repayment period of 10 years, not counting periods of authorized deferment and forbearance.[11]

FFELP lenders may also offer graduated and income-sensitive repayment plans to borrowers. Borrowers have the option to pick a different repayment plan each year. If borrowers waive their selection, rules of the standard repayment plan apply.

As previously noted, the interest rate on subsidized Stafford loans is currently the 91-day T-bill rate plus 1.7 percentage points when the borrower is in school or in other nonpayment periods and the T-bill rate plus 2.3 percentage points when the borrower is in repayment. The rate is reset on July 1 each year, based on the T-bill rate from the last Treasury auction conducted before June 1.

Unsubsidized Stafford Loans

Unsubsidized Stafford loans differ from subsidized Stafford loans in three key respects: They are not need-based, the government does not pay interest during in-school periods, and loan limits are higher. The unsubsidized Stafford loan is not need-based; the approved amount is not limited by the same financial need formula used for subsidized Stafford loans. Instead, the expected amount of the unsubsidized Stafford loan may be considered all or part of the estimated family contribution. Interest on the unsubsidized Stafford loan is paid entirely by the borrower and is not subsidized by the federal government. The borrower is not required to make interest payments during in-school, grace, and other deferment periods. However, interest accrued during such periods may be capitalized (added to principal) when the loan enters repayment for

[10] "Unmet need" is, in its simplest terms, the borrower's cost of attendance minus estimated family contribution minus estimated financial aid from other sources.

[11] A deferment is a period during which borrowers do not need to pay principal and the federal government pays interest. Borrowers are eligible for a deferment under certain conditions, such as going on to further schooling. A forbearance is a period during which borrowers do not need to pay principal but are responsible for any interest that accumulates. The borrower's eligibility for a 10 year repayment schedule is conditioned by the requirement that the borrower repay at least $600 per year. The 1998 amendments to HEA provide for a repayment schedule of up to 25 years for "new borrowers" who accumulate more than $30,000 in FFELP loans.

the first time or when it returns to a repayment status following a period of deferment. Higher loan limits are available on unsubsidized Stafford loans to independent students.[12] The maximum borrower's interest rate is the same as for subsidized Stafford loans.

PLUS Loans

The PLUS loan is available to parents for their student dependents. For a school to certify a PLUS loan, both the parent and student must meet program eligibility requirements. For the PLUS loan, HEA requires the lender to determine that the parent borrower does not have an "adverse credit history" before making the loan and to use as a minimum the guidelines for determining adverse history in the student financial aid regulations. If the lender discovers adverse credit history in the applicant's credit bureau report, it can still make the loan if it documents "extenuating circumstances." Even without extenuating circumstances, the lender can still make the loan if the borrower obtains a creditworthy endorser.

Like the unsubsidized Stafford loan, the PLUS loan is not need-based and may replace all or part of the student's estimated family contribution. Also like the unsubsidized Stafford loan, payments of interest on the PLUS loans fall upon the borrower entirely, with no federal subsidy. Payments of interest are not required during periods of authorized deferment but may be capitalized upon expiration of the deferment.

Unlike both types of Stafford loans, there is no fixed annual or aggregate limit for PLUS loans. A loan may not be made, however, for an amount greater than the student's cost of attendance less his or her estimated financial aid. Also unlike Stafford loans, the PLUS loan has no grace period-it enters repayment upon full disbursement, unless the borrower happens to qualify for a deferment. Unless payments are deferred, the first payment due date for a PLUS must be established within 60 days of final disbursement.

Consolidation Loans

Consolidation loans are new originations that do not contribute to the increases in outstanding balances because they replace already existing loans. Borrowers may consolidate not only FFELP loans but also FDLP loans and even loans authorized by legislation other than HEA.

When the consolidation loan program started, its purpose was to give a borrower who had multiple loans - possibly from different lenders, different guarantors, and even from different loan programs - the opportunity to have them combined into a single debt. The consolidation loan offers two unique advantages. First, the borrower who has been dealing with multiple servicers and repayment schedules can deal with a single servicer and single repayment schedule. Second, a combined debt of more than $7,500 qualifies the borrower for a repayment term longer

[12] Independent students are students who, by meeting certain regulatory criteria, are presumed to receive no financial support from their parents. A student is considered "independent" who is at least 24 years old; who is a graduate or professional student, a veteran of the U.S. armed forces or married or has dependents other than a spouse. A financial aid administrator may also classify a student as independent under special circumstance, even if none of these criteria are met.

than the maximum 10 years generally available on Stafford and PLUS loans. For example, consolidation loan borrowers with at least $20,000 of combined qualifying debt may qualify for a repayment period of 20 years, and borrowers with more than $60,000 for the maximum 30 years.[13] Periods of deferment and forbearance are not included.

Borrowers who consolidate their loans give up certain rights tied to the underlying loans subject to consolidation. These rights include certain deferments and all service and employment cancellations available to borrowers under the Federal Perkins Loan Program. Borrowers also give up the variable interest rate of the FFELP and FDLP loans consolidated in lieu of a rate fixed for the life of the loan.

Another, more recent, use of the consolidation loan is the resolution of defaults. A borrower who has defaulted on an FFELP or FDLP loan may pay that defaulted debt in full by consolidating it. This benefits the borrower in two ways. First, the borrower's credit history is improved - in some cases immediately and in other cases after payments have been made. Second, resolution of the default qualifies the borrower for additional student financial assistance. A borrower qualifies for consolidation of a defaulted loan by making a satisfactory repayment arrangement with its holder, as defined in regulations.

The availability of loan consolidation to borrowers must be considered as part of the analysis of any market mechanism proposal. Loan consolidation allows borrowers to change lenders. However, the ability to switch lenders affects the perceived federal benefit that could result from some of the market mechanism models discussed in this report.

Student Loan Volume

FFELP loans represent more than half of federal student loans outstanding and newly originated, and in both FFELP and FDLP, Stafford loans make up the bulk of overall outstanding loans. At the end of the federal fiscal year 2000, the total amount of outstanding FFELP loans was about $166 billion, while about $58 billion of FDLP loans were outstanding. During fiscal year 2000, FFELP loans accounted for about 63 percent of new loan volume and FDLP for about 37 percent. Tables 3 and 4 detail loan balances and new loan originations, respectively, for fiscal year 2000.

[13] This is based on the outstanding balances of all loans in the qualifying underlying loan programs.

Table 3: Outstanding Loan Balances at End of Fiscal Year 2000

Loan	Federal Family Education Loan Program Amount	Federal Direct Loan Program Amount	Total Loans Amount	Total Loans Percent
Stafford:				
Subsidized	$85,084	$23,976	$109,059	48.7%
Unsubsidized	37,410	15,487	52,897	23.6
PLUS[a]	14,552	3,609	18,160	8.1
Consolidation	29,082	14,643	43,725	19.5
Total	**$166,128**	**$57,714**	**$223,841**	**100.0%**

Note: Dollars are in millions. Totals do not sum because of rounding.
[a]Includes loans from Supplemental Loans for Students, a program that no longer exists.
Source: Department of Education

Table 4: Loan Originations in Fiscal Year 2000

Loan	Federal Family Education Loan Program Amount	Federal Direct Loan Program Amount	Total Amount	Total Percent
Stafford:				
Subsidized	$11,259	$5,785	$17,044	37.8%
Unsubsidized	9,126	4,240	13,366	29.6
PLUS	2,326	1,318	3,644	8.1
Consolidation	5,695	5,369	11,065	24.5
Total	**$28,406**	**$16,712**	**$45,119**	**100.0%**

Note: Dollars are in millions. Totals do not sum because of rounding.
Source: Department of Education.

Participants in the Student Loan Programs

FFELP involves many participants, including borrowers, schools, lenders, loan servicers, guaranty agencies, and Education. Some of these participants also have roles in FDLP.

Borrowers

Every eligible student pursuing a post secondary education at least half-time at a participating school meeting certain requirements may obtain a loan. In addition, in some cases parents of undergraduates may also borrow through FFELP or FDLP. The loans can be used to pay for tuition and education-related expenses at eligible 4-year colleges and universities, 2-year community colleges, private colleges and universities, and for-profit trade and technical schools (sometimes referred to as proprietary schools).

For Stafford loans, student borrowers do not have to make payments while in school or in other authorized periods of nonpayment. Depending on the borrower's income, and the income of his or her family, he or she may be responsible for the interest that accrues during these periods of nonpayment, in which case it is added to the loan principal at the beginning of the repayment period. The maximum interest rate a borrower may be charged is set in legislation as the 91-day T-bill rate plus an add-on of 1.7 percentage points when the borrower is in school or in other nonpayment periods and 2.3 percentage points when the borrower is in repayment. The borrower rate is adjusted annually, based on the new value each year of the T-bill rate, but it is capped at 8.25 percent no matter how high the T-bill rate.

Schools

Eligible schools decide whether to participate in FFELP, FDLP, or both; most schools choose to participate in only one of the programs. In both programs, schools make various certifications necessary for a borrower to obtain a loan, and in FDLP they perform certain loan origination functions as well. Within FFELP, schools currently play a pivotal role in borrowers' choice of guaranty agency and originating lenders. Borrowers in FFELP schools are legally free to choose among all eligible FFELP lenders. However, schools often provide borrowers a recommended list of lenders based on the services, loan terms (such as rate discounts for good performance), and other key services offered by the lenders.[14] Most borrowers use a lender that their school recommends.

Lenders and Secondary Markets

Lenders originate and hold FFELP loans. HEA limits eligibility to originate and hold these loans primarily to (1) banks and certain other savings institutions, (2) pension funds, (3) insurance companies, (4) one state or private, nonprofit agency for each state, and (5) with certain limitations, schools. Lenders pay the government an origination fee of one-half percent for each loan and, in the case of consolidation loans, an interest rebate. The government offsets interest and special allowance payments owed to lenders to collect a 3-percent borrower origination fee and authorizes lenders to charge the borrower for this fee. Although lenders may discount the fee to the borrower, so that the borrower may not pay the full 3 percent, the lender must still pay the full fee to the government. The 1998 Amendments and regulations further specified the circumstances under which lenders may charge borrowers a reduced origination fee.

[14] Service competition by lenders involving "inducements," such as unsolicited mailings of loan applications or paying schools for referrals of loan applicants, is not permitted.

An eligible lender can approve and originate loans. Once the loan is originated, the lender can

- keep the loan on its books and earn either a positive or negative return and interest spread based on the lenders' yield and its own interest expenses and other expenses,
- sell the loan to a purchasing lender and record the gain or loss on sale, or
- securitize the loan by selling the loan to a trust that has beneficial ownership of the loans and funds its holdings by selling debt to investors and book a gain or loss, depending on the terms of the transaction.

In the FFELP student loan market, secondary markets refer to financial institutions that purchase student loans from lenders and provide liquidity to the student loan market. In 1972, the Congress chartered a secondary market, Sallie Mae, as shareholder-owned government-sponsored enterprise (GSE) to provide liquidity for the student loan market. Some other lenders also serve as secondary markets for FFELP loans. In addition, under HEA, each state can designate a not-for-profit secondary market to help ensure that every student at every eligible institution can receive a loan and to provide liquidity to originators.

Financial institutions other than those defined as eligible by HEA are not eligible for direct participation as lenders in FFELP. However, HEA authorizes the use of trustees as eligible lenders to hold loans for the benefit of others without regard to the latter's own eligibility. Sallie Mae is eligible to hold loans originated by eligible originators. Certain secondary markets, those that are not designated by their state to be the state's eligible lender, as well as other non bank financial institutions, use trustees to originate loans.

Sallie Mae and some secondary markets also effectively manage or service an additional amount that was held by originators with which the secondary markets had "pipeline" arrangements. Some of the funding for loans in the pipeline is borrowed by the originating lender from the subsequent purchaser.[15]

In 1999, approximately 4,000 lenders took part in FFELP. Both loan holdings and loan originations were concentrated in larger institutions, as shown in tables 5 and 6. The top 10 loanholders held 62 percent of outstanding loan balances and the top 10 loan originators originated 52 percent of the loan volume in 1999. Both loan holdings and loan originations have become increasingly concentrated over the past decade.

[15] Under such arrangements, the secondary market performs all or some of the marketing, origination, funding or servicing functions for the originating lender of record while the student is in school. The loan is transferred to the secondary market when or before the loan enters repayment pursuant to a forward purchase agreement, often at a predetermined price.

Table 5: Concentration of FFELP Outstanding Loan Balances at End of Selected Fiscal Years

Fiscal year	Share held by top 10 loanholders	Share held by top 50 loanholders
1988	42%	61%
1992	51	73
1995	55	82
1997	58	87
1999	62	89

Source: Department of Education.

Table 6: Concentration of FFELP Loan Originations in Selected Fiscal Years

Fiscal year	Share originated by top 10 originators	Share originated by top 50 originators
1988	26%	53%
1992	32	58
1995	37	69
1997	45	78
1999	52	81

Note: Originations exclude consolidation loans.
Source: Department of Education.

FFELP lenders' yield and eligibility requirements are set by federal statute and enforced by Education, while the market determines the lenders' cost of funds. The formula for lenders' yield for Stafford loans in FFELP--the largest component of FFELP - is based on a CP index. Lender yield is the CP rate plus 1.74 percentage points while the borrower is in school or during other nonpayment periods and CP plus 2.34 percentage points when the borrower is in repayment. The lender yield is adjusted quarterly with new values of the CP rate. This rate applies to new FFELP loans made between January 1, 2000 and June 30, 2003.

After July 1, 2003, the Stafford formula is scheduled to change to a markup of 1 percentage point over the rate for "comparable maturities" of Treasury securities, as determined by the Secretary of Education in consultation with the Secretary of the Treasury. This new rate will be both the borrower's rate and the lender's yield. Such a change is likely to either narrow the interest margins earned by lenders or increase their funding risks. Some study group members expressed concern that lenders may respond by exiting from FFELP which could potentially limit borrower access to student loan funds and disrupt ongoing working relationships among schools, lenders and students. According to a 1998 Treasury study, switching to a long-term reference rate with a

1 percentage point markup, as specified in the law, "need not imply an immediate crisis in the market for guaranteed student loans but it could be problematic for lenders in the longer term."[16]

A special allowance payment (SAP) is a quarterly payment that the federal government makes to FFELP lenders. It equals the difference between the rate a borrower pays and what the current formula provides for lender yield. Thus, if the lender yield exceeds the maximum borrower rate, the government pays the difference to lenders in the form of the SAP. If the difference is negative, the lender receives the borrower rate and no SAP. The SAP is intended to maintain a competitive yield for the lender, permitting borrowers to pay lower rates while encouraging lender participation in FFELP. If CP declines, the quarterly lender yield declines, and so does the SAP generally. The minimum or "floor" yield to lenders is the borrower's rate for the year. The SAP is designed to make sure the lenders receive a reasonable rate of return on average. However, because risks and costs can vary across borrowers and lenders, so can returns.

The borrower's interest rate set in legislation is a maximum, and FFELP lenders may offer lower interest rates to borrowers. Most often lenders charge FFELP borrowers the maximum rates at the outset but then offer some rate reductions during repayment. For example, they may reduce rates after the borrower makes a certain number of payments on time or if the borrower chooses to make payments though electronic funds transfers. Many lenders now offer rate reductions upon loan origination or discounts on the 3 percent origination fee.

Loan Servicers

Loan servicers undertake the processing necessary to ensure that cash flows of the loans are recorded and transferred to and from lenders, guaranty agencies, and Education. Loan servicing is more concentrated than loan holdings or loan originations, with the top two loan servicers accounting for about 50 percent of the loan servicing market. Holders of student loans can service their own loans or they can contract out for loan servicing to be performed by another entity; this is known as a third-party servicer arrangement.[17] If servicing does not conform to procedures Education established by regulation, the lender may not be reimbursed if the borrower defaults. Better servicing can reduce the risk of default and thus lower government costs. Additionally, schools benefit since higher defaults could threaten some schools' eligibility to participate in FFELP.

Guaranty Agencies

Guaranty agencies administer the federal guarantee on FFELP loans, confirm borrower eligibility, monitor the status of loans, provide delinquency and default aversion counseling, and

[16] Treasury, The Financial Viability of the Government-Guaranteed Student Loan Program (Washington, D.C.: Feb. 1998).

[17] Third-party servicers are not subject to eligibility limitations by organizational type. However, they must meet federal requirements of administrative capability and financial responsibility, and they are subject to audit by Education. Eligible lenders remain responsible for the performance of their legal duties despite any delegation of functions to third-party servicers and must monitor their servicers' activities.

provide claims adjustments. FFELP loans are guaranteed by one of 36 nonprofit agencies designated by the Secretary of Education. If a loan goes into default, the guaranty agency generally pays the lender 98 percent of principal and accrued interest. The federal government then generally reinsures 95 percent of the guaranty agencies' payments to lenders and also pays them fees for loan processing and issuance, account maintenance, and default aversion. Guaranty agencies also retain a portion of the collections they are able to make after a loan has gone into default. The government also directly guarantees or reinsures FFELP lenders against the inability of guaranty agencies to fulfill their guarantees because of insolvency.

As long as the lender is in compliance with the regulations, the guarantee substantially limits FFELP lenders' losses due to borrower default. Federal reinsurance is the ultimate support for the value of a loan if the borrower defaults, but it is available only if the guaranty agency correctly enforced federal regulations and attempted to collect from delinquent borrowers. If the loan servicing and collections are not done in accordance with federal regulations, the guarantee can be voided and can create losses for the guaranty agency.

Guaranty agencies are authorized to collect a single insurance premium from FFELP borrowers of not more than 1 percent of the principal amount of their loans. Before 1998, some guaranty agencies had selectively reduced or eliminated this insurance premium. Since reauthorization, the elimination of guarantee fees has become widespread because of market pressures. Any fees collected go into an agency's federal reserve account, which consists of federal funds that the guaranty agency maintains.

The Department of Education

HEA provides the structure of FFELP program requirements and then authorizes the Secretary of Education to administer the program. Among the Secretary's responsibilities is the promulgation of regulations to provide detail on how requirements will be implemented. Sometimes, the statutory requirement is very specific, in which case, the regulation simply restates the statutory language (e.g., loan limits). In other cases, the statute expresses the requirement in only the broadest terms and gives extensive authority to the Secretary to define standards of compliance such as due diligence with respect to loan collection.

Education is also involved in two types of cash flows relevant to this report. First, it reimburses a guaranty agency after the guaranty agency pays a lender for a defaulted loan. Second, it makes certain payments to lenders, including the difference between the borrower's interest rate and the lender's yield, for all borrowers, and interest during in-school and other authorized periods, for borrowers with subsidized Stafford loans.

Education is also responsible for

- determining a student's eligibility to receive federal student financial assistance;
- gatekeeping, monitoring, and enforcement activities for postsecondary schools;
- recognizing accrediting agencies and administering the Quality Assurance and Experimental Sites program, the Default Reduction Initiative, and Closed School activities;

- monitoring the participation of guarantors, lenders, secondary markets, and third-party servicers in FFELP;
- managing FDLP;
- collecting and resolving defaulted FFELP and FDLP loans;
- maintaining a centralized database on individuals who apply for and receive federal student financial assistance;
- managing the financial aspects of the Federal Student Financial Aid Programs, such as receipt, disbursement, accounting, and financial reporting for federal funds;
- developing and disseminating information about the federal student loan programs;
- developing cost estimates for the student loan programs; and
- providing technical support and information for financial aid administrators.

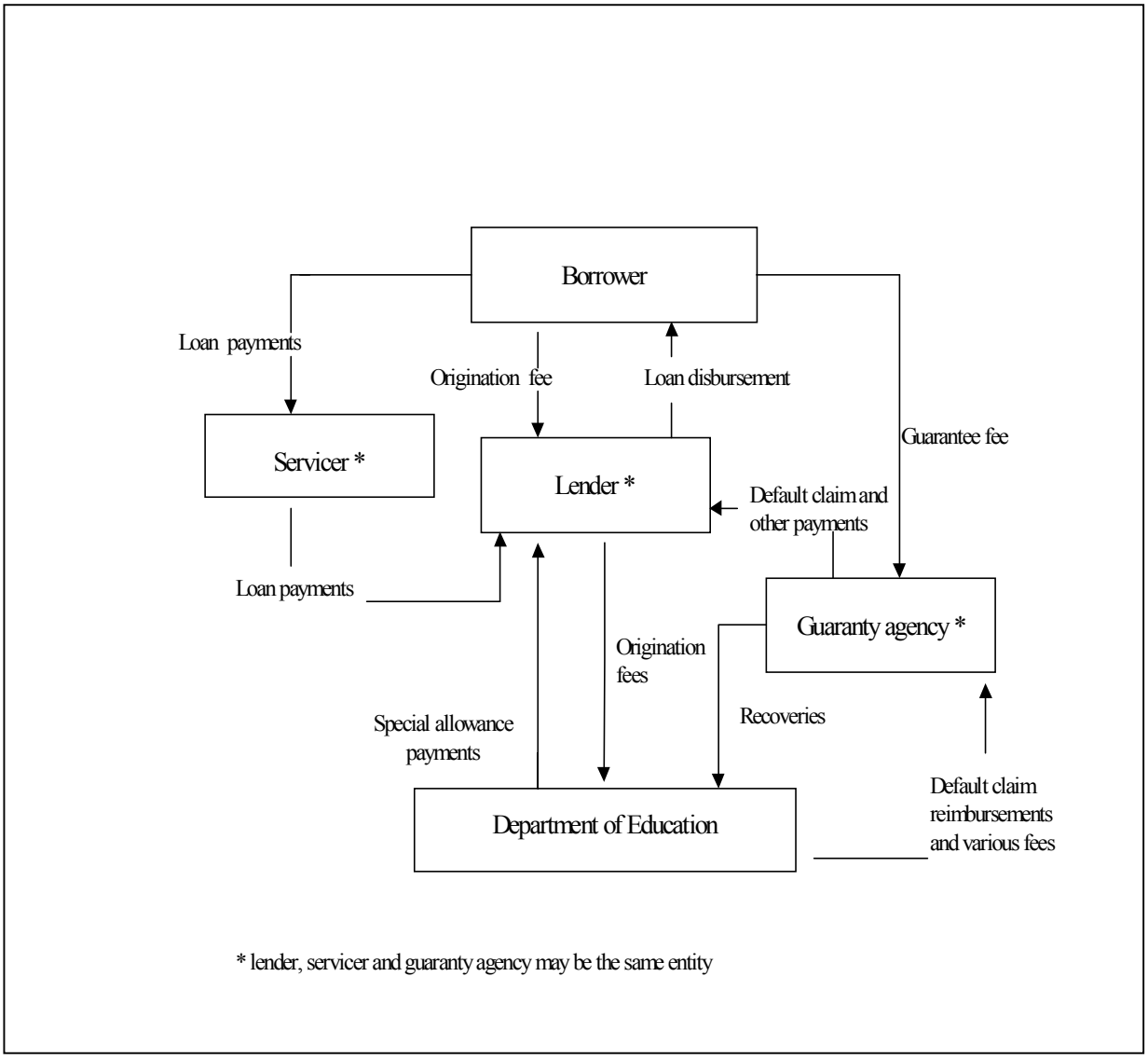
Federal costs of FFELP include borrower defaults and loan discharges, borrower interest subsidies, and payments to lenders and guaranty agencies. The federal costs associated with FFELP for fiscal year 2000 are presented in table 7. Figure 1 depicts the cash flows in an FFELP program loan to and from the student borrower, school, lender, loan servicer, guaranty agency, and Education.

Table 7: Federal Costs for the FFELP Fiscal Year 2000

Default claim reimbursement	$1,646,483,901
Interest benefits	1,943,067,250
Special allowance payments	975,825,865
Loan processing and issuance fees	149,799,369
Account maintenance fees	180,000,000
Death, disability, and bankruptcy	309,476,408
Collection costs	78,558,740
Total	**$5,283,211,533**

Source: Department of Education.

Figure 1: Cash Flows for an FFELP Loan



FDLP AND ITS EFFECT ON THE STUDENT LOAN MARKET

The Student Loan Reform Act of 1993, a part of the Omnibus Budget Reconciliation Act of 1993, created FDLP. At the time the program was permanently authorized, competition in the student loan market was limited and more than one student loan borrower in five defaulted on his or her guaranteed student loan within two years of graduation. Lenders and guarantee agencies had less financial incentive to prevent default and taxpayers bore the brunt of expensive and unnecessary lender and guarantee agency subsidies. Paperwork, procedures and schedules were

different depending on the lender, creating confusion and administrative burden for schools and student alike. FDLP gave students and schools a choice and improved the student aid delivery system. FDLP gives schools more control over the loan process by offering one set of procedures, fast and reliable delivery of funds, less paperwork, electronic loan processing, and a customer service emphasis.

FDLP borrowers complete one application, the Free Application for Federal Student Aid. FDLP borrowers have one lender and one servicer; they know who to contact for deferments and repayment questions because their loans are not sold. Direct Loan's income contingent repayment plan allows graduates to repay their loans as a share of income and is designed to give borrowers the flexibility to meet their student loan obligations without causing undue financial hardship.

FDLP has achieved billions in savings for students and taxpayers. Student borrowers in both FDLP and FFELP have benefited from reduced fees and lower interest rates, a total of $9 billion in savings. By eliminating subsidy payments to lenders, direct lending has saved more than $4 billion over the past five years. The costs of the guaranteed loan program have also fallen--federal subsidies for banks and guaranty agencies have been pared down, saving taxpayers an additional $2 billion. The default rate has fallen for eight straight years from 22.4 percent in 1993 to a record-low 6.9 percent today. Collections on defaulted loans have tripled, from $1 billion to $3 billion. FDLP also saves taxpayer dollars by replacing the high-cost private capital needed to originate guaranteed student loans with lower-cost government funds. FDLP uses competitively-awarded servicing contracts based on the provision of the best value to the government, students and taxpayers.

Increased competition in FFELP since FDLP's creation has spurred innovation and industry standardization, improved service, and reduced fees and interest rates for all borrowers. Examples of improvements in FFELP include initiatives to simplify processing and expedite delivery for participating institutions, a Common Manual to apply consistent policies, new products provided by guaranty agencies, borrower incentives for repayment, discounts on origination and guaranty fees, and enhanced entrance and exit counseling.

MANDATE IN THE 1998 AMENDMENTS TO HEA AND THE STUDY GROUP'S WORK

The Study Group and Its Objectives, Scope, and Methodology

The 1998 amendments to HEA mandated that GAO and Education form a study group to identify and evaluate a means of establishing a market mechanism for the delivery of student loans. This study group consisted of representatives of Treasury, OMB, CBO, entities making FFELP loans, other entities in the financial services community, other participants in the student loan programs, and other individuals designated by the Comptroller General and the Secretary of Education. (See app. I for the full text of the mandate and app. II for a list of study group members.) The group met as a whole four times before the public release of a draft of this report, and various group members corresponded with GAO and Education between group meetings as well.

The mandate calls for the evaluation of at least three different market mechanisms relative to 13 criteria. We grouped the evaluation criteria into four sets, as shown in table 8.

Table 8: The Four Sets of Evaluation Criteria

Set	Related criteria from the 1998 HEA amendments
Description of model, including variations	• A description of how the mechanism will be administered and operated (12) • The proposed Federal and State role in the operation of the mechanism (11) • Transition procedures (13)[a]
Costs, savings, and effects on subsidies for program participants	• The cost or savings of loans to or for borrowers, including parent borrowers (1) • The cost or savings of the mechanism to the Federal Government (2) • The cost, effect, and distribution of Federal subsidies to or for participants in the program (3)
Effects on lender participation, loan availability, and quality of service	• The effect on the diversity of lenders, including community-based lenders, originating and secondary market lenders (7) • The availability of loans to students by region, income level, and by categories of institutions (10) • The effect on loan availability during a transition period (13)[a] • The effect on investment in human capital and resources, loan servicing capability, and the quality of service to the borrower (6) • The degree to which the mechanism will provide market incentives to encourage continuous improvement in the delivery and servicing of loans (9)
Simplicity, regulatory burden, and program integrity	• The effect on the simplicity of the program, including the effect of the plan on the regulatory burden on students, institutions, lenders, and other program participants (5) • The effect on program integrity (8)

Note: The numbers in parentheses refer to the number assigned to the specific criteria in the legislative mandate. The analysis related to the fourth criterion - the ability of the mechanism to accommodate the potential distribution of subsidies to students through an ICR option - was similar across all the models. Rather than repeat our analysis of this criterion for each model, we discuss it separately in chapter 7. Therefore, this criterion does not appear in this table.

[a]We split the thirteenth criterion, on transition procedures, into a descriptive part and a part related to loan availability issues.

The group solicited proposals for market mechanisms that might meet the intent of the mandate. Group members, as well as outside observers, submitted proposals for consideration. GAO and Education considered all submissions and grouped them where we saw some similarities within

the proposals. For example, under the general idea of conducting an auction for the right to make FFELP loans, there were two main possibilities as to how such an auction might be conducted, as well as many different considerations at the level of specific auction design. Rather than selecting one of the main possibilities and a specific set of auction design decisions, we analyzed this type of model in general, weighing the advantages, disadvantages, and tradeoffs involved in the different possible choices.

In study group meetings and other conversations with group members, including those with staff from the other government agencies, we discussed the various models and their implications. Two of the group meetings were devoted to generating ideas about possible changes to FFELP, including some general factors to consider and some specific proposals. In the third meeting, the group discussed preliminary analysis results, and in the fourth meeting, the group discussed a draft of this report.

GAO and Education also researched comparable programs where they existed, such as other federal auctions and the experiences of student loan programs in other countries. We used previously published reports, material available from the Internet, and contributions from study group members for much of this research.

The Five Models Discussed in This Report

The potential changes to FFELP discussed in this report are grouped under five general models:

- adjustments to the current system,
- loan origination rights auction,
- loan sale,
- federal funding, and
- market-set rate.

A model involving adjustments to the current system would change the process of setting lender yield by building upon competition for loan originations, purchases, and servicing that is a part of FFELP today. Proposals within this model include (1) making periodic incremental downward adjustments in the lender yield while monitoring any resulting changes in lender participation; (2) using information about lenders' cost of funds and servicing costs to set the yield; (3) establishing an independent blue ribbon commission to gather information, analyze data, and either set lender yield or recommend a yield level to the Congress; and (4) using information from secondary market loan sales transactions to determine the value lenders place on loans, and establishing a one-time payment to lenders based on this value to replace the quarterly SAP.

A loan origination rights auction would require lenders to bid to participate in FFELP. The borrower’s interest rate and other loan terms would be set through legislation or regulation and could remain the same as today. Lenders would generally submit bids to participate in FFELP loan origination, and bidders offering the best terms to the government would win the

allocations. Variations within this type of model differ as to how restrictive the outcomes would be. A volume procurement auction would require lenders to bid on loan volume at a particular interest rate (or price, for a predetermined interest rate), perhaps for volume within different sectors of schools.[18] An actual origination rights auction, in contrast, would require lenders to bid for the right to originate at groups of schools.

The loan sale model presumes that private lenders would purchase loans sometime after they are originated by the government or by some entity under government contract. The loan would be government property until sold at auction. The government would assemble packages of loans, and private lenders would evaluate the packages and submit bids. Loans would carry the same borrower terms as today, and the lender yield would be set legislatively and could be the same as the borrower's interest rate. Loan origination could be performed by the federal government; by schools; by private lenders that bid to originate and service the loans but operate under government contract; or by state agencies or some other entity. Loans could be sold immediately after origination or held until a borrower graduates or otherwise completes schooling, at which time a borrower's loans could be sold as part of a package. Loan servicing could be performed by the purchaser, if servicing responsibilities are sold with the loan, or by some other entity.

The federal funding model would adjust funding costs for FFELP lenders ultimately determining lender's net yield. Private lenders would continue to originate loans, except that they would be allowed to borrow funds from the federal government to make FFELP loans. The interest rate at which they borrow, in conjunction with the lender yield on FFELP loans, would determine lenders' net yield. This process could be made mandatory for lenders who want to participate in FFELP, or it could be offered as an option, with lenders still being allowed to fund student loans through traditional methods. Once lenders receive these funds - or if they choose not to participate - everything else would proceed functionally as in the current system. The funds lenders borrow from the government could be payable on either a regular amortization schedule or a schedule tied to borrower repayments on the FFELP loans made with the federal funds. Finally, the markup over a Treasury-based interest rate, such as the 91-day T-bill rate or the 10-year Treasury bond rate, could be fixed, or lenders could bid on the markup.

In a market-set rate model, the borrower or the school shops among lenders for the best attainable interest rate. Unlike with the other models, the borrower's interest rate would no longer be set by legislation. Instead, it would emerge from negotiations between lenders and borrowers or between lenders and schools.[19] The resulting rate would thus be both the borrower's rate and the lender's yield. Loans would still be federally guaranteed, and lenders would face no limitations on the amount of loans they could originate and hold. Under this model, some borrowers may pay a higher interest rate. Possible variations could limit the potential effects on disparate groups of borrowers. For example, one alternative would place a

[18] For instance, volume for 2-year and 4-year schools, or public, nonprofit private, and proprietary schools, could be offered in separate auctions.

[19] Lenders would likely assume that enough common characteristics exist across borrowers at a school to enable them to give the same rate to all a school's borrowers rather than to try to negotiate with each borrower.

limit on the maximum range of rates or fees a lender could offer.[20] Another possibility would be for the government to provide subsidies to borrowers who cannot otherwise obtain low interest rates from lenders.

The models discussed in this report might or might not be accompanied by changes in the role of guaranty agencies in FFELP. To analyze such changes, the models would have to be specified in more detail than is possible in this report. For this reason, we do not discuss possible changes in guaranty agencies' role.

The models discussed in this report may present budgetary complications. The Credit Reform Act of 1990 changed the budget treatment of federal credit programs to put the scoring of direct and guaranteed loans on an equal footing. Under credit reform, loan program budget estimates for a given fiscal year reflect the net present value of all future subsidy costs--including interest subsidies, default costs, loan discharges, etc.--associated with loans originated in that year. (Federal administrative costs are excluded from these calculations.) For the student loan programs, these estimates are generated for the administration by Education using a government-wide credit subsidy model developed by OMB. Projected program cash flows for the life of each loan cohort are generated by an Education model and discounted by the OMB credit subsidy model using a discount rate based on Treasury instruments with a comparable maturity to that of the underlying loans. For the student loan programs, this comparable maturity rate is the 10-20 year bond rate. Shifts in the timing of payments and receipts would need to be considered within the context of a credit budget. To analyze such changes, or "score" the proposals for budgetary purposes would require more detailed specifications than is possible in this report. For this reason, we do not calculate or compare the budgetary costs of models presented in this report.

[20] This would be similar to a limit that exists in the Federal Housing Administration (FHA) insurance program. FHA limits the variation between the highest and lowest "mortgage charge rates" (analogous to FFELP origination fees) that a lender may offer to any borrower within a given time period to no more than 2 percentage points within well-defined markets, as defined by geographic region and "risk characteristics," among other factors.

CHAPTER 2
ADJUSTMENTS TO THE CURRENT FFELP SYSTEM

The proposals to adjust the current FFELP system focus on lenders' sensitivity to interest rates, secondary market trends, and lender costs. Whether or not the Congress maintains its legislative authority to set the lender yield, each of these adjustments would modify the process, making FFELP a system more responsive to student loan market conditions. Each of the four proposals would preserve the existing relationships between borrowers, schools, lenders, and other FFELP participants, while relying on the acquisition of new or better information to adjust lender yields. Current options for borrowers to consolidate loans would continue to be available under these proposals. These proposals would affect lender yields similarly to the proposals discussed in other chapters. However, the proposals discussed in this chapter may take a longer time to affect lender yields than would the proposals discussed elsewhere in this report. Each adjustment to the current system could reduce federal costs but possibly at the expense of discounts that lenders currently offer to some borrowers. The extent to which each proposal can realize these savings depends on choices regarding design and implementation.

DESCRIPTION OF MODEL AND VARIATIONS

Each of the proposals maintains the structure of FFELP while changing the mechanism for determining lender yield. The proposed adjustments to the system include

- incremental adjustments proposal,
- cost of funds proposal,
- proposed blue-ribbon commission that would set lender yields, and
- loan transaction proposal that would use data from secondary market transactions to improve the yield-setting process.

Incremental Adjustments

Under the incremental adjustments proposal, the Congress would reduce the lender yield incrementally, either annually or as needed, while carefully monitoring lender participation after each adjustment. If such a reduction in lender yield caused lender participation to drop to a dangerously low level or caused an erosion of service quality, the Congress could raise the lender yield until it believed that lender participation and service quality were once again at acceptable levels. Legislation would be necessary for each adjustment, as it is in today's program, unless the Congress specifically delegated the rate-setting role to an executive agency or to an independent government commission.

Cost of Funds

The cost of funds proposal relies on lenders' cost data to determine lender yield. Data on lenders' costs would include the actual expense to lenders associated with raising funds, loan

origination, and loan holding, as well as an estimation of servicing costs deemed reasonable to maintain high-quality service to borrowers. On the basis of these factors, the Congress could determine an appropriate differential between the cost of funds and the cost of servicing. This differential could be applied to the determination of a market-based lender yield. The Congress, an executive agency, or an independent government commission could administer the cost of funds approach.

Blue-Ribbon Commission

There are two distinct ways in which a blue-ribbon commission could be organized. It could be an advisory commission whose members could include expert staff from the executive branch, representatives from the student loan or banking industries, and recognized authorities on higher education finance. This type of commission could consider the costs of funds, loan transaction cost, or other similar information. The commission could also, for example, recommend different methods for paying or calculating special allowance payments. The Congress would retain responsibility for setting the rate and could accept or reject the commission's recommendation as it saw fit. Alternatively, the Congress could establish the commission as an executive branch agency or as an independent federal entity and could give it the responsibility of determining the lender yield.

Loan Transaction Information

This proposal would use data from loan transactions to gauge the underlying value that participating FFELP lenders place on loans. Under this plan, the government would collect information on the terms and conditions of secondary market transactions in the existing FFELP. This information can serve as the basis for a modified determination of lender yield.

Another component of this proposal is its modification of the SAP that lenders receive. Under this plan, the SAP would be made to the loan holder only once, either when the loan was initiated or when and if consolidation or refinancing occurred, rather than quarterly as in the current FFELP. The proposal empowers an executive agency or an independent commission to establish this single supplemental payment for loans made each year rather than having the Congress continue to legislate the SAP. The amount of the single supplemental payment would be influenced by data gathered from transactions in the secondary market. Additionally, the amount of a modified SAP could vary according to lender size, student loan activity, type of loan or type of school, or any other characteristics deemed relevant.

COSTS, SAVINGS, AND EFFECTS ON SUBSIDIES FOR PROGRAM PARTICIPANTS

Each of the proposed adjustments to the current system could potentially reduce or increase the federal operating costs of FFELP. Further, each of these proposals makes two assumptions regarding the current FFELP: (1) lenders' participation in the student loan program is contingent on profit sustainability, and (2) the current lender yield results in profits beyond those necessary to maintain sufficient active lender participation. These assumptions, and the corresponding

reforms these proposals envision, drive the cost and savings effects for program participants, potentially saving money for the taxpayers.

If the lender yield is lowered incrementally and lender participation is maintained, the action may cost lenders a portion of their profits while saving the government some of what it otherwise would have spent on payments to lenders. If, however, the lender yield is reduced below this equilibrium point, profits for participating lenders could fall and lenders could leave the system. Smaller lenders (those with low volume or high cost) would likely be the first to exit the program. However, remaining lenders may likely make up for this loss by acquiring the assets of the outgoing firms or simply by increasing lending activity. Thus, remaining lenders would grow larger, further concentrating the market. Larger lenders, able to operate at a lower cost per dollar of loan originated, may pass savings on to borrowers or might make improvements to service delivery.

Like the incremental adjustments proposal, the cost of funds approach may result in either costs or savings to the federal government and program participants. The cost of funds approach calls for a mechanism by which lenders can detail and report their costs and the government can form objective judgments to analyze and justify these estimates. Although some savings may be realized through reduced federal payments to lenders, this proposal would impose additional administrative costs to the federal government because cost data are not readily available. If these figures were accessible, the government could assess cost data by using a number of criteria. These could include the types of students or schools served.

An additional question is the role that the government should have in determining the accuracy of cost estimates. The outcome of these decisions directly affects both the federal administrative cost of implementing the model and the federal payments to lenders in the program. If, for example, lenders document substantial costs for raising funds and the government accepts these figures, then the lender yield could rise, costing the government money. In contrast, if the government chooses to contest these figures, it may become embroiled in a political and controversial investigation that could stall FFELP loan delivery.

The use of loan transaction information may result in decreased costs for the taxpayer. For example, while the federal government would incur some costs associated with the pursuit and analysis of information regarding secondary market loan sales, these costs may be small compared to any potential savings from reduced payments to lenders.

EFFECTS ON LENDER PARTICIPATION, LOAN AVAILABILITY, AND QUALITY OF SERVICE

The adjustments to the current system would likely affect the current FFELP structure less than the models discussed in other chapters. These proposals could preserve or possibly improve the quality of loan service. There is consensus among the study group members that FFELP lenders have responded to the competitive pressure introduced by FDLP.

The incremental adjustments proposal may reduce the number of lenders in the program. For example, the adjustment process may initially set the lender yield low enough to force out

lenders with high costs or low volume whose profitability is threatened. If these lenders leave the program, they may find re-entry costs prohibitively high should the yield be raised in a subsequent adjustment. Determining what number of lenders is sufficient is a value-laden assessment. Mergers and acquisitions resulting in fewer lenders but the same loan volume and more efficient service provision may be desirable. However, a decline in lender participation might reduce loan availability or disrupt services to students and schools, at least temporarily.

The cost of funds proposal relies more heavily on lender information to set the lender yield by considering lenders' operating costs as a component of the yield determination. Thus, the cost of funds proposal has the potential to improve the quality of service that lenders provide. If lenders recognize that the yield will reflect their funding costs as well as their service costs, they may have the incentive to reduce costs for borrowers or to enhance service delivery by purchasing or developing new technology. While these actions would have clear benefit to borrowers, reports of higher lender costs would force the government to increase the yield, raising federal FFELP costs.

Merely establishing a blue-ribbon commission would not affect lender participation, loan availability, or lender diversity. Establishing a blue-ribbon commission is a procedural reform, and commissioning an independent entity alone to implement adjustments to FFELP would do little to alter the provision of loans or the quality of service. Consequently, the extent to which loan availability, service quality, or lender diversity would change hinges on the rate setting strategy the blue-ribbon commission chose to employ.

The implementation of the loan transaction proposal relies on lender-provided information. This proposal requires the government to collect secondary market sales data. The extent to which this data collection requirement may burden lenders is unclear.

SIMPLICITY, REGULATORY BURDEN, AND PROGRAM INTEGRITY

Each of the proposals presents logistical and regulatory challenges to the Congress. The incremental adjustments approach calls for careful monitoring of lender activity, while the cost of funds proposal represents a shift toward oversight and evaluation of lender operations. The potential unwillingness of lenders to release cost information, as well as the difficulty inherent in analyzing it, would present challenges to implementing this proposal. While the blue-ribbon commission approach aims to free FFELP from congressional control, the extent to which an independent entity could effectively oversee a program of this size remains unknown. Although a blue-ribbon commission might be empowered to set the yield, it would be subject to administrative requirements that might leave it open to the same pressures that the Congress currently faces. Finally, collecting data from loan sale transactions may complicate FFELP administration, requiring the government to track the prices associated with secondary market loan sales. Since lender yield would still have to be set by the Congress or some other entity under each approach rather than emerging from a market process, the rate-setting mechanism still might not be free from the political process. Any of these approaches could result in either more or less regulation, while all would impose new administrative burdens.

The incremental adjustments proposal could entail regulatory burden for FFELP. Specifically, the incremental adjustments proposal would require careful monitoring of lender response each time an adjustment was made. The need for timely information and for prompt action to counteract excessive adjustments requires special considerations. Some mechanism would be required to halt further downward adjustments from negative consequences such as lender departure. In addition to regulatory burden, this proposal could create significant administrative burden. If this proposal were to be implemented, it might require delegation to an independent entity such as the blue-ribbon commission. In any case, some entity would have to monitor the program and make recommendations as to further changes.

Concerns exist regarding implementation of the cost of funds proposal as well. Administering a cost of funds model would introduce additional data collection needs. This proposal requires annual development of two sets of proprietary lender information (costs of raising funds and an estimation of servicing expenditures) for use in setting lender yield. Collecting and verifying lender cost information could present new challenges. The data collection process itself may be impeded by the complexity of lender transactions (such as securitizations and forward purchase agreements) and by the variation in lender structure (free-standing, part of a holding company whose main focus is student loans, part of a larger bank for which student loans may be a small business). Inaccurate and inadequate data would limit the government's ability to manage this program. The proposal would also require the subsequent modification of lender yield if lender cost data indicated that the current rate were inappropriate. Some of these assessments, however, require normative judgments about the degree to which costs should vary by the types of schools and students lenders serve.

Many of these aforementioned challenges to simplicity and regulatory burden apply to the blue-ribbon commission proposal. Panel selection might become politicized and controversial. Additionally, while the establishment of the commission would reduce the direct congressional role in setting yield, it remains unclear whether the commission would be advisory or authoritative, how the panel would access data, and whether consensus would be required for commission decisions. The commission would need the authority to gather relevant data as well as the resources needed to analyze them. Implementation decisions would also center on the type of legislation necessary to establish the commission's tasks and objectives and on the delegation of congressional staffers for administrative and substantive assistance.

The blue-ribbon commission may or may not remove the setting of the lender yield from the political process. If the commission were advisory, then the Congress would still be responsible for setting the rate and could still face political pressure from FFELP participants who disagreed with its recommendation. If the commission were a federal agency, then the Congress would not face such pressure directly but the commission might. Political pressure on the commission's decision could be especially great if the Congress required it to publish a public notice of its proposed decision and respond to public comments on its proposal before implementing it. The Congress has imposed such a requirement on most federal agency rulemaking decisions. If the Congress decided to exempt the commission from this requirement, then the commission would be less subject to political pressure but would also be less accountable to the public and might lose the benefit of information that public comments could provide.

One federal agency that functions like a blue-ribbon commission is the Postal Rate Commission (PRC). PRC is an independent executive agency that recommends postal rates to the U.S. Postal Service's board of governors. When the Postal Service requests a rate change, it must provide PRC with data about the relevant costs. Before making a rate recommendation, PRC must hold public hearings, which include testimony and written submissions from the Postal Service, its competitors, and others who are interested. In making a recommendation, PRC must consider nine legislatively established criteria as well as the record of its hearings. The postal ratemaking process is lengthy and complicated. There is a process for modifying or rejecting PRC recommendations, but those recommendations have usually been accepted without modification.

The loan transaction information proposal requires the government to monitor lender participation and corresponding secondary market transactions. However, collecting and verifying private secondary market transaction information might present challenges especially considering the proprietary nature of agreements between secondary market participants. Carefully monitoring the secondary market will demand administrative oversight, forcing decisions about what information will be gathered and how it will be analyzed.

The federal government, or its designated blue-ribbon commission, could periodically auction a limited amount of direct loans as an alternative source of secondary market information. However, Education has rejected this alternative. At the inception of FDLP, students and schools were promised that Direct Loans would never be sold and that borrowers and schools would have a single point of contact—FDLP would be the sole originator and servicer of these loans. Although existing law authorizes sales of Direct Loans, additional statutory provisions would be required to ensure comparable terms, conditions, and benefits to keep borrowers and schools whole. Thus, FFELP lenders' bids on Direct Loans may not accurately reflect the value they place on FFELP loans. In addition, selling a portion of the FDLP portfolio may present budgetary challenges. Under federal credit reform, such sales could possibly be recorded as a loss. Such losses would require Education to reallocate potentially scarce budgetary assets to cover the losses. Other ways to offset the subsidy cost of selling Direct Loans would be to 1) have FDLP purchase some FFELP loans; and 2) have FDLP securitize some of the loans in its portfolio.

Finally, implementing an auction of FDLP loans could increase administrative burden. Also, if insufficient competition existed, it could threaten the integrity of the bidding process. Even the auction of a limited number of FDLP loans would involve decisions on who would facilitate the auction and how competition would be preserved. Auctions design issues and the importance of competition are discussed in detail in app. III. Results of the analysis for the adjustments to the current system are summarized at a broad level in table 9.

Table 9: Summary of Analysis for Adjustments to the Current System Model

Description of model, including variations	• All proposals maintain current roles and relationships for FFELP participants. • Proposals use information from the marketplace, for example, data on lenders' cost of funds or secondary market sales - to set the yield level. • Might involve establishing a blue-ribbon commission to either set the yield or recommend a yield level to the Congress.
Costs, savings, and effects on subsidies for program participants	• Federal FFELP costs could increase or decrease, but are more likely to decrease. • Savings to the taxpayer, if any, could come at the expense of some of the discounts that lenders currently offer to some borrowers.
Effects on lender participation, loan availability, and quality of service	• Loan availability should not be greatly affected if adjustments are incremental. • The number of lenders in the program could fall if adjustments force out lenders with low volume or high cost. • Service quality would be subject to the same pressures.
Simplicity, regulatory burden, and program integrity	• Relationships between FFELP participants would change little. • Oversight of lender operations, and required data gathering and analysis, might prove difficult. • Blue-ribbon commission would require administrative framework.

CHAPTER 3
LOAN ORIGINATION RIGHTS AUCTION

The auction model would require lenders to bid for the right to originate and obligate them to lend FFELP loans. Auctions rather than the legislative process would set the interest rates that lenders would receive. If the auctions were sufficiently competitive, bidding would eliminate any excess in what the government currently pays lenders and would give lenders a continuing incentive to reduce their costs. Therefore, auctions have the potential to reduce federal FFELP costs. The effects of auctions on borrower interest rates, the distribution of federal payments to lenders, the quality of service, and the burden on borrowers and schools are uncertain. The effects depend on the details of auction design as well as on a number of assumptions about markets that may or may not be valid in relation to the student loan program. The diversity of lenders would likely decline unless special provisions were made to ensure the participation of small lenders. Students' and parents' access to loans could be reduced during the transition to auctions and, depending on auction design details, perhaps permanently. The federal government would have to develop new regulations to govern the conduct of the auctions and, in particular, to preserve competition in bidding. Students, lenders, and schools would all bear the cost of adjusting to the auction system.

DESCRIPTION OF MODEL, INCLUDING VARIATIONS

In origination rights auctions, lenders would bid for the right to originate student loans. The federal government would develop regulations to implement the auctions and would maintain its current subsidies to borrowers. Major choices that must be made in designing the auctions include

- whether the auctioned rights are rights to originate all loans at particular schools or groups of schools or rights to originate a specified volume of loans at any of a number of schools,
- whether origination rights or volumes are grouped by school,
- whether each student borrower is allowed to keep all loans with a single lender, and
- which bidding method is used, including whether lenders bid on the interest rate they would receive on loans they originated or on the price they pay to originate loans at a predetermined interest rate.

Basic Model and Role of Participants

All versions of the origination rights auction model share several features. The borrower's maximum interest rate, in-school subsidy policy, and some other loan terms would be set through federal legislation or regulation, as at present. Lenders would bid for the right to originate loans. They would indicate the prices that they were willing to pay or the interest rates they were willing to accept for the right to originate at particular schools or to originate a specified loan volume. In each auction, a lender could submit a single bid or multiple bids that incorporated

different prices or interest rates. The government would sort bids by price or interest rate, and the most favorable bids would win the right to originate. It would be possible to set aside some origination rights for non bidders. However, most rights would be determined through the bidding process. Lenders who submitted winning bids would be allowed to originate only at the schools where they won rights or to originate only the volume they won. Except for non bidders who received set-asides, non winning lenders would not be permitted to originate loans. Lenders could buy and sell origination rights after the auction but before loans were originated. They could also buy and sell loans after origination, as they do today.

The federal government could be responsible for conducting the auctions and ensuring borrower access to loans. The government would determine whether lenders were eligible to participate in FFELP. Education might also act as a loan consolidator, as in the current FDLP. It might need to establish procedures to ensure that eligible borrowers received loans and that winning lenders performed as promised. The government would also need to establish procedures to ensure access to loans when loan demand exceeded auctioned loan volume. In addition, it might need to re-auction loan origination rights for lenders who could not or would not perform as promised, although it would be possible instead for these rights to be resold in the secondary market. During the transition from the current system of setting FFELP lender yield to an auction system, the government would have to develop new regulations to govern the conduct of auctions, develop the expertise to conduct auctions itself or contract with a non government entity to conduct the auctions, educate lenders and borrowers about auctions, and act as lender of last resort to ensure that all eligible borrowers have uninterrupted access to loans. No state role is envisioned beyond that which now exists in FFELP.

Major Variations on the Model

Several high-level decisions must be made in designing an origination rights auction model. The items to be auctioned could be either the rights to originate all loans at particular schools or groups of schools or the rights to originate a specified volume of loans at any of a number of schools. Origination rights or volumes may or may not be grouped by school. The right to lend includes the obligation to lend. A variety of bidding methods could be used. Finally, each student borrower may or may not be allowed to keep all loans with a single lender.

The study group considered three alternative designs for an origination rights auction. In the "rights auction," lenders would bid for the right to originate all loans at a particular school or group of schools. In the "volume procurement" design, lenders would bid for a specified loan volume that could be used at any school and either all winning lenders would pay the same price or each would pay the price it bid. The Income Dependent Education Assistance (IDEA) version resembles volume procurement, except that each winning bidder would pay the price bid by the next highest bidder and there would be an explicit provision for income-contingent repayment. These three proposals illustrate but do not exhaust the range of available alternatives. Other combinations of auction characteristics are possible. For example, the right to originate at specific schools could be combined with each winner's paying the next highest bid price. Any origination rights auction could either include or exclude income-contingent repayment.

The three versions of the model illustrate a fundamental choice that must be made in the design of an origination rights auction. In the rights auction version, lenders bid on the right to originate loans to students at a particular school or group of schools. In the volume procurement and IDEA versions, they bid on a specified volume of loans, which they can lend to students at any of a number of schools.

Under any alternative, schools may or may not be grouped together when origination rights are auctioned. In rights auctions, grouping would mean that lenders would bid for the right to originate at particular groups of schools. In volume procurement, it would mean that lenders would bid on a volume of loans that they could use only at particular groups of schools. Under either alternative, the rights to originate at all groups of schools could be sold at the same auction, or else a separate auction could be held for each group. At the opposite extreme, the government could decide not to group schools but to require lenders to bid for the right to make loans to all FFELP-eligible students, regardless of school.

A variety of bidding methods could be used. One important issue is whether lenders would bid on the interest rate they would receive on loans they originated or on the price they would pay to originate loans at a predetermined interest rate. If lenders bid on an interest rate, then that rate would likely be expressed as a markup over a reference rate that bears some relationship to lenders' cost of funds, such as a T-bill rate or the commercial paper rate. If lenders bid on a price, then their bids might or might not be allowed to be negative. (A negative bid would be one in which the lender asked the federal government to pay it a specified price in order to make it willing to lend.) Issues related to auctions, including the grouping of schools and the choice of bidding method, are discussed further in app. III.

A final important design choice is whether to allow each borrower to borrow from a single lender, at least for the duration of a particular degree program. For example, a student entering an undergraduate program could be given the right to borrow from one lender until he or she completed that program, even if that lender did not win the right to originate at that student's school for all the years that the student was enrolled in that program. Alternatively, a student could be required to switch lenders whenever his or her previous lender lost the right to originate at his or her school.

COSTS, SAVINGS, AND EFFECTS ON SUBSIDIES FOR PROGRAM PARTICIPANTS

Auctions have the potential to reduce federal FFELP costs, but their ability to realize this potential depends on whether there is sufficient competition in bidding. The frequency with which auctions were held, the definition of auctionable rights, and the choice of bidding method could also affect federal costs. The distribution of federal payments to lenders would be more uneven in some types of auctions and unchanged in others. Auctions could reduce all borrowers' interest rates, raise some borrowers' rates, or leave all borrowers' rates unchanged.

Origination rights auctions have the potential to reduce federal FFELP costs if there is sufficient competition among lenders. If auctions were competitive enough, then the federal government could reduce its payments to lenders, because auctions would eliminate lenders' excess profits (if any), because they would encourage lenders to lower their costs, or both. However, the student

loan origination market at present may not be sufficiently competitive for origination rights auctions to achieve these results.

In an ideally competitive auction, bidding competition among lenders would eliminate any excess profits that lenders would otherwise receive. The bidding process would ensure each lender just enough profit to make that lender willing to remain in FFELP. Furthermore, the winning lenders would be the ones with the lowest loan origination costs. App. III describes an ideally competitive auction, explains how such an auction would produce these results, and shows how the less-than-ideal auctions that would be likely to take place could produce most of the same results.

Auctions can reduce the federal government's FFELP costs by reducing federal payments to lenders. Currently, the federal government pays lenders the difference between the lender yield and the maximum borrower interest rate. If lenders currently receive excess profits, then auctions could eliminate those profits, thereby reducing the lender yield and reducing federal payments to lenders. (If lenders do not currently receive excess profits, then auctions would not reduce their profits.) Regardless of whether lenders currently receive excess profits, lenders might have an ongoing incentive to reduce their costs by developing less expensive methods of originating loans. Reduced lender costs would mean reduced federal payments to lenders. However, if auctions were not sufficiently competitive, then they could increase federal FFELP costs by increasing federal payments to lenders.

Evidence from other federal auction programs suggests that origination rights auctions could produce a net saving to the federal government. In the Health Education Assistance Loan (HEAL) program,[21] under which lenders bid for the right to originate student loans to students of the health professions, the markup in excess of the 91-day Treasury bill rate that the federal government paid the largest lender during the repayment period was cut in half between 1993 and 1998. The Federal Communications Commission's (FCC) auctions of wireless spectra have yielded revenues exceeding their costs.

The current student loan market, however, may not be competitive enough to enable origination rights auctions to produce savings for the federal government. As chapter 1 showed, a limited number of large lenders hold a large share of loans in the student loan market; furthermore, it may be costly for new lenders to enter the market. If the limited number of lenders is the result of natural scale economies, the associated cost savings have the potential to benefit all participants. If the limited number of lenders results in less competition and excess lender profits, this market structure is undesirable, with or without auction mechanisms, and is best addressed by our nation's laws regarding monopolistic practices. In either case, because the number of lenders is limited, the dominant lenders' influence on the winning bids could conceivably lead to FFELP costs that were as high as or higher than current costs. Lenders might also collude in setting their bids. The relatively small number of lenders in the market would make collusion easier. FCC's wireless spectrum auctions illustrate this problem and some solutions to it. In some FCC auctions, bidders were able to signal their bidding strategies to other bidders by using the last

[21] In contrast to FFELP or FDLP, the HEAL program never exceeded more than $500 million in insurance authority for a single year. The experiences under the HEAL program may or may not indicate the potential for savings through the adoption of an auction mechanism in a larger program.

three digits of the amount bid or by strategically withdrawing from the bidding. FCC corrected the former problem by setting minimum bid increments that bidders were required to use in raising bids. It solved the latter problem by limiting the number of withdrawals a bidder was allowed to make during an auction.

A competitive secondary market in loan origination rights could at least partially compensate for insufficiently competitive auctions. Such a market, which does not currently exist, would enable lenders to buy and sell rights to originate student loans outside the auctions, and would add a new layer of complexity to the program.[22] The Environmental Protection Agency (EPA) sulfur dioxide emission allowance auctions provide an example. Allowances sold at those auctions have been concentrated in the hands of a relatively small number of firms. However, the secondary market, on which allowances are traded outside auction, is much larger than the auction market. After the first few years of EPA auctions, the secondary market, rather than the auctions, appears to have determined the price of allowances. Because the auction price reflected the secondary market price, insufficient competition in the auction might have been less of a problem than it would have been in the absence of a secondary market.[23]

Although sufficiently competitive auctions could reduce federal payments to lenders, their overall effect on FFELP costs would also depend on details of the auction design. The frequency with which auctions were held, the definition of auctionable rights, and the choice of bidding method could influence FFELP costs. They could do so either by affecting federal payments to lenders or by affecting the cost of conducting auctions.

At present, all lenders receive a uniform federal payment equal to the difference between the lender yield and the maximum borrower interest rate, both of which are set by law. Some types of origination rights or volume procurement auctions would lead to an unequal distribution of federal payments to lenders, while others would not change the current pattern of equal payments to all lenders. Both the choice of bidding method and the grouping of schools would affect the distribution of federal payments to lenders. A full discussion of competition, auction design and frequency, bidding methods, and the grouping of schools is in app. III.

In addition, if borrowers do not have the option to borrow from a single lender until they complete their educational program, these proposals could increase the attractiveness of consolidation to borrowers. If lenders expect the use of consolidation to increase, they will bid less, and federal revenues from the FFELP auctions could decline.

[22] A secondary market in origination rights would differ from the existing secondary market, in which loans are bought and sold after they have been originated.

[23] FCC and EPA auction models have numerous elements of dissimilarity with a loan origination rights auction. End users of wireless spectrum communication often have readily available alternatives and thus are not likely to suffer if an auction winner does not provide such service. Further, consumers may actually benefit if the holders of emission rights are not exercised. Caution is necessary in using these auctions as models for an origination rights auction.

EFFECTS ON LENDER PARTICIPATION, LOAN AVAILABILITY, AND SERVICE QUALITY

Auctions could either reduce the quality of service or have no effect on it. In the absence of special provisions, they could reduce the diversity of lenders. The definition of auctionable rights, the choice of bidding method, and the frequency with which auctions were held could affect borrower and lender access to FFELP as well as the quality of service. Some students and parents could have difficulty obtaining loans during the transition to an origination rights auction. Some transitional challenges might be anticipated and thus minimized through the use of a pilot auction program, although results from a pilot might be difficult to interpret if participating lenders are uncertain as to the likelihood of the program's continuation.

Auctions may or may not reduce service quality but are unlikely to improve it. The number of lenders permitted to serve each school, the frequency with which auctions were held, and the method by which bids were evaluated could also affect service quality.

Auctions might shift the balance of competition in the student loan market toward price competition and away from service competition. At present, FFELP lenders compete to a limited extent on the basis of price, through discounts to preferred borrowers. They also compete on the basis of service. Auctions would force lenders to place more emphasis on price competition, since the major (and, in most variants, the sole) criterion for determining auction winners would be the price or interest rate bid. It is possible, although not certain, that lenders would pay less attention to service as they paid more attention to price.

Service quality could be higher if multiple lenders were allowed to serve each school than if there were only one lender per school. If more than one auction winner could serve each school, then students could choose among lenders. Lenders would have an incentive to compete for students on the basis of service quality. This incentive would not exist if only one lender could win the right to serve each school.

Finally, service quality could be improved if the government were allowed or required to take service quality into account in choosing auction winners, but there are important drawbacks to this. One option would be to evaluate bids on the basis of service quality as well as price or interest rate. Another would be to prequalify bidders using service quality criteria and then conduct the auction on the basis of price or interest rate alone. These procedures would make auctions more complex than if bids were evaluated solely on the basis of price or interest rate. The added complexity could deter small lenders from participating in FFELP. Loans that had service quality features as legally enforceable terms would also be more difficult to sell in the secondary market than loans without such features.

Auctions could increase, decrease, or have no effect on lender diversity in the short term but might reduce it in the long term.[24] Provisions to protect small bidders' access to FFELP could be built into the auction design. Small-bidder protections may make auctions more competitive as well as ensure small lenders' participation in FFELP. The choice of bidding method, the number of lenders allowed to originate at each school, and the frequency with which auctions were held could also affect lender diversity.

In the short term, auctions may have any of several effects on the number of FFELP lenders. They may increase lender participation by enabling new lenders to enter the market on relatively equal terms with existing lenders. Or they may have no effect on participation if entry into the origination market is so expensive that no new lenders are willing to enter. It is also possible that auctions would increase large lenders' dominance of FFELP market. Large lenders would have several advantages over small lenders in origination rights auctions. Because they can usually obtain loan funds more cheaply and spread their costs over a larger volume of loans, large lenders would generally be able to outbid their smaller competitors. In addition, auctions would necessarily make lenders uncertain about their prospects of continuing to participate in FFELP. This uncertainty may be more likely to deter small lenders than it would be to deter large lenders. In the long term, it is possible that auctions would gradually reduce the number of lenders, although we do not know how likely this outcome is. Lenders who did not win origination rights in one auction might leave FFELP permanently because it may be expensive to re-enter the origination market. If losing bidders dropped out permanently after each auction, then the number of bidders would gradually decline. Only a few large lenders might be left to originate student loans.

Evidence from the HEAL program neither clearly supports nor clearly refutes this argument. The number of HEAL bidders declined during the last 4 years of the program.[25] (These are the only years for which we were able to obtain comparable data.) However, this decline may have stemmed from lenders withdrawing from the auctions after the Congress decided to end the program. Moreover, the number of lenders receiving loan origination rights did not fall continuously. There were four or five large HEAL lenders in the last few years of the program until the very last year. Furthermore, lenders entered and re-entered rather than dropping out permanently after losing at auction.

Small-bidder protection measures and the choice of bidding method could affect the diversity of lenders. Auctions can be designed to enhance small bidders' ability to compete. More lenders might participate in auctions if all auction winners paid the same price than if each paid a different price. Lender participation might also be greater in an auction with multiple rounds of bidding than in one with a single round. However, a single-round auction might be more attractive to small lenders because it would be simpler than a multiple-round auction. Lender diversity would probably be greater if more than one lender were allowed to originate at each

[24] As chapter 1 showed, the student loan industry is highly concentrated and is becoming more concentrated. If the trend toward reduced competition in the industry were expected to continue regardless of FFELP rules, then auctions' effects on lender diversity would have to be evaluated relative to this trend.

[25] Most HEAL lenders were also large FFELP lenders and considered HEAL lending complementary and marginal in importance to their FFELP lending activities. Many schools found the HEAL program unsatisfactory, believing it unstable and unpredictable.

school than if there were only a single lender per school. More lenders would likely participate in FFELP if multiple lenders could serve each school. For more details on these issues, see app. III.

An additional complication associated with the volume procurement proposal would be the challenge of estimating the annual borrowing needs of students. An under allocation of loan volume could result in delays in funding and in loan access problems for student loan providers. The Congress might want to include additional requirements to ensure that loans were available to all eligible borrowers. For example, it could require the federal government to serve as a lender of last resort or design a mechanism to increase the allocation for lenders who were approaching their allocated limit. Alternatively, the federal government could pay lenders to serve borrowers who would otherwise not receive loans. (Allowing lenders to submit negative price bids at auction - that is, requesting that the federal government pay them to serve certain groups of schools - would be one way of implementing such payments.)

Auctions should be held when borrowers can receive loans when they need them. After an auction is completed, time is needed to process bids and notify the winning lenders. The winning lenders, in turn, need time to disburse loans after they are notified. For borrowers to receive loans when they need them, all these things have to be done before the start of the school term. If there were a secondary market in origination rights, then trades on this market would also have to be timed to enable lenders to receive funds and disburse loans in time for the beginning of school. Schools' academic calendars vary widely, and academic programs can start at any time of year. Therefore, it would not be possible to link the timing of auctions to that of loan disbursements. However, it would be possible for loans to be disbursed continuously between auctions. For example, auctions could be held once every 3 to 5 years, and the winners of each auction could use the origination rights they won at any time between that auction and the next year's auction.

Finally, the transition to auctions could temporarily disrupt both student and parent access to FFELP loans. Lenders would require some time to become accustomed to the auction system. Some lenders might at first miss deadlines or fail to submit payments that the government might require before the auctions. Some might decide not to participate in the initial auctions. Those who did participate might not bid on as many origination rights as they would if they were more familiar with the auction process. The government might experience delays in processing bids and notifying auction winners. For all these reasons, auctions could initially reduce FFELP loan volume. The federal government could maintain student and parent access to loans during the transition period by acting as the lender of last resort or by paying private lenders to do so. In addition, the federal government could identify potential access problems during the transition by conducting an auction pilot program before implementing an auction system for all FFELP loans. Using knowledge gained from the pilot program, it could then take steps to minimize those problems.

SIMPLICITY, REGULATORY BURDEN, AND PROGRAM INTEGRITY

Because insufficient competition could threaten the integrity of the bidding process, auctions would require special rules to preserve competition. The definition of auctionable rights, the choice of bidding method, and the frequency with which auctions were held could affect the simplicity and integrity of FFELP and the burden that auctions would place on lenders, students, and schools. Students, schools, and lenders would all bear the burden of adjusting to new regulations and market practices. Some transitional challenges could be anticipated and thus lessened through the use of a pilot program.

To preserve the integrity of auctions, the federal government would have to adopt and enforce regulations to maintain competition in bidding. Rules to prevent bidders from colluding would be necessary. The nature and complexity of these rules would depend on the kinds of collusion to which a particular type of auction could be vulnerable. FCC, for example, set minimum bid increments to prevent bidders from signaling their bidding strategies by using the final digits of their bids.

Collecting the data needed to administer this program could present new challenges. Tracking the results of auctions and administering a program with origination rights auctions or volume procurement auctions requires data not currently available. At a minimum, the government would require the ability to monitor eligible lenders' loan portfolios by school and loan volume. Insufficient data would limit the government's ability to manage this program.

All auctions would require rules to ensure that bidders were able to pay the amounts they bid. Without such rules, non-serious bidders could distort competition. Other federal auctions provide examples of rules that could be adopted in an origination rights auction. In its sulfur dioxide emission allowance auctions, EPA requires each bidder to send a certified check or letter of credit to cover its bid before the auction. (This rule is feasible only for sealed-bid auctions, in which each bidder submits a single bid.) FCC requires bidders in its wireless spectrum auctions to submit refundable deposits to cover the cost of placing bids. A final option, not used in any federal auction, is to require all potential bidders to show some evidence of their ability to pay. One way of implementing this option is to use the current FFELP eligibility criteria as evidence of ability to pay. Another alternative is to require FFELP-eligible lenders to pass additional ability-to-pay tests before allowing them to participate in the auction.

The greater the total number of auction winners, the longer and more complex the process of determining winners is likely to be. Length and complexity will probably be greater, for example, the larger the number of groups into which schools are divided and the greater the number of winners per group or per school. The longer and more complex the bid evaluation process, the greater the burden on lenders. If lengthy and complicated bid evaluation methods caused delays in the disbursement of loans, then they could also impose burdens on borrowers.

Bidding methods differ in their simplicity, speed, and vulnerability to collusion. An auction that has a single round of bidding is faster than one with multiple rounds, and the bid evaluation

process is simpler. Allowing lenders to bid on groups of schools that they define complicates the evaluation of bids. (See app. III for details.) It is simpler and faster to evaluate bids on the basis of price or interest rate alone than to include service quality criteria in the evaluation. Finally, as appendix III explains, a multiple-round auction may be more vulnerable to collusion than a single-round auction, and an auction in which each bidder pays a different price could be either more or less susceptible to collusion than one in which all bidders paid the same price.

Frequent auctions could impose substantial burdens on lenders, students, and schools. Because participating in auctions would cost lenders both money and time, more frequent auctions would be more burdensome to lenders. In addition, according to some school representatives in the study group, students and schools value the ability to deal with a single lender. Therefore, more frequent auctions could impose a greater burden on schools and students by disrupting long-term student-lender and school-lender relationships.

Any origination rights auction system would require students, schools, and lenders to adjust to new regulations and changes in the student loan market that resulted from auctions. The nature of the regulations adopted to implement auctions would depend heavily on the specifics of the auction design. However, those regulations would probably have to be very detailed, and monitoring lender compliance could be costly. Regardless of the particulars, lenders would have to learn how to participate in auctions and might be subject to new regulations to ensure their ability to use the origination rights they won. All origination rights auctions would restrict students' and schools' ability to work with the lenders of their choice, and those with a single winning lender per school would eliminate their ability to do so. Students, lenders, and schools would all have to adapt to the changes in loan availability, lender and borrower interest rates, and service quality that could result from auctions. Table 10 summarizes the analysis for the loan origination rights auction model at a broad level.

Table 10: Summary of Analysis for Loan Origination Rights Auction Model

Description of model, including variations	• Lenders submit bids to originate loans. Some win right to originate and others do not. • Auction could be conducted for the right to originate at specific schools or groups of schools or for a certain loan volume that could be used at any of a number of schools. • Other major design options include grouping schools, choice of bidding method, whether a borrower keeps all loans with one lender.
Costs, savings, and effects on subsidies for program participants	• Federal costs could lessen if competition is sufficient. • Distribution of payments to lenders would be unchanged or more uneven, depending on auction type. • Borrower interest rates could decline for all borrowers, remain unchanged for all borrowers, or increase for some borrowers.
Effects on lender participation, loan availability, and quality of service	• Loan origination costs could lessen if competition is sufficient. • Service quality may decline or remain unchanged. • Diversity of lenders is likely to decline unless auctions included small-lender protections. • Schools ability to work with preferred lenders could be reduced. • Loans would not be available to all students in some types of auctions.
Simplicity, regulatory burden, and program integrity	• Program integrity would require new rules to preserve competition. • Burden on students, lenders, and schools would differ depending on auction type. • Students, lenders, and schools would bear the burden of adjusting to new auction regulations developed by the government.

CHAPTER 4
LOAN SALE

Under the loan sale model, the federal government, or some entity other than private lenders, would originate all student loans, and the government would later sell them at auction in a secondary market to the highest bidding lenders. Preferably, the government would elect to sell loans immediately following origination or later when the borrower enters repayment. Because the federal government would be responsible for loan origination, and the loan guarantee terms could change, the federal role in FFELP would be vastly different from today. Purchasers of the secondary market loans could include today's FFELP lenders as well as new participants, however some current lenders, including lenders who currently originate loans but subsequently do not hold them, might not choose to participate. The federal costs of the loan program could also be lower, partly because the government's lower cost of securing the funds to make loans and reduction in fee payments to guaranty agencies for services related to verifying lender eligibility. If there is sufficient competition, then the auction among secondary market participants could reduce federal FFELP costs. Secondary market concentration would be likely to increase with this mechanism, perhaps reducing the participation of small community-based lenders. Loan availability would be universal, with the federal government being the only program lender. Centralizing the loan origination and distribution functions may simplify the loan process. Schools and borrowers would deal only with the federal government or the designated entity to obtain loan aid. Adjustment to the new system could prove burdensome for some lenders.

DESCRIPTION OF THE MODEL, INCLUDING VARIATIONS

The loan sale model and variations discussed in this chapter share several features. Generally, student loans would be originated by some entity other than private lenders. The terms of the loan, such as the borrower's maximum interest rate and the in-school subsidy policy, would be set through legislation, as at present. Packages of student loans—with or without a guarantee—would be purchased privately at periodic sales or auctions. While the purchaser buys loans, either the purchaser or some other entity may perform the servicing functions. In each auction, a lender could submit a single bid or multiple bids that incorporated different prices. The government would sort bids by price, and the highest bids would win the right to purchase loans. The government could set a minimum price below which it would not sell any of the loans it originated. It would be possible to set aside some loan packages for non bidders. However, most purchase rights would be determined through the bidding process. A variety of bidding methods could be used, as described in app. III.

Proposals for this model vary as to who originates loans, how loans are grouped when they are sold, who is responsible for servicing loans, whether the loans sold are federally guaranteed, and whether payment is due in full at the completion of the loan sale. Origination could be carried out by a federal entity or by private contractors, as is currently the case in FDLP. The government could sell these loans immediately or it hold off selling the loans until a borrower

enters repayment. If the loans are sold with government servicing, the purchaser is buying the stream of payments and the government needs to contract for servicing.[26] If the loans are bundled and auctioned off without government servicing, purchasers can arrange for servicing themselves or possibly retain the services of the government contract servicer. Loan bundles are less valuable if they are sold without a guarantee than if they are sold with a federal guarantee. Allowing lenders to make payments in installments could foster competitive participation in loan sales.

Several options are available for loan origination. One alternative would be to give a government entity (such as a new government-sponsored enterprise) the authority to originate federally guaranteed student loans. The government could maintain the origination procedures in place for FDLP, using private contractors to originate loans. Another option would be for the government to require the student-lending industry to charter a mutually owned corporation that would originate and provide short-term funding of loans. The objective would be to structure the entity's ownership and transactions so as to give it an incentive to keep down its costs. Achieving that objective could be difficult without competition, however.

Loans from particular groups of schools may or may not be bundled together when loans are auctioned. Grouping by schools would mean that lenders would bid for packages of loans that were originated at particular groups of schools. The loans from each grouping of schools could be sold at the same auction, or else a separate auction could be held for each group. In defining groups of schools, several alternatives are possible. An Internet-accessible interface could inform potential purchasers of the characteristics of loans bundled as a package. Issues related to the grouping of schools at auctions are presented in app. III.

There are several options for servicing loans after they are sold at auction. One would be that the government could keep the responsibility of servicing loans that were later sold at auction. This could possibly increase auction proceeds by attracting bidders who do not have servicing capacity but are interested in receiving interest income and loan principal. Auction proceeds would also vary, depending on whether the lenders expect the government's servicing to be more or less costly than other servicing options. If the purchaser services loans, combining the loans of all borrowers reduces the burden on each borrower. Some provisions would need to be made for loan consolidation and loan deferment. Either the government or the private lender could consolidate the loans if the borrowers return to school.

Another issue is whether the loans or securities are sold with federal guarantee. If the loans are sold with a guarantee, then the guarantee could be set at the current 98 percent of principal or it could be set higher or lower. The government would have to decide on the extent of the guarantee and would have to define the conditions under which the guarantee applies, such as death or bankruptcy. One variation is to have no explicit federal guarantee or due diligence requirements. In another variation, lenders could have the right to resell the loans to Education

[26] A variation on loan sales with government servicing is selling securities backed by student loans. Securitization is the process of selling debt securities to investors with groups of loans serving as collateral for the debt.

in the event of death, disability, bankruptcy, or the borrower's election of ICR. Other variations assume that federal loan guarantees continue as with the current program.

One variation would allow lenders to pay for bundled loans in installments. Installment financing arrangements could be tied to the loan payment revenues received by the purchasing lender or to a fixed repayment schedule, and the appropriate interest rate would have to be determined. Either arrangement reduces the initial funds needed to purchase loan bundles, thereby potentially increasing lender participation.

An additional variation of this model was developed by Treasury and presented in outline form to the study group. This variation has not been reviewed by the study group and can be found in app. V.

COSTS, SAVINGS, AND EFFECTS ON SUBSIDIES FOR PROGRAM PARTICIPANTS

Loan sales could potentially raise enough revenue to reduce overall federal FFELP costs, but their ability to realize this potential depends on whether there is sufficient competition in secondary market bidding. The federal government (or some entity acting on its behalf) will originate all loans, taking advantage of the government's ability to raise funds at a lower interest rate. The grouping of loans into packages, the choice of bidding method, and the frequency with which auctions are held could also affect federal costs. If competition prevails, there could be a lower net lender yield. However, insufficient competition could threaten the integrity of the bidding process. Auctions are not likely to affect borrower costs. However, schools participating in FFELP could incur costs in implementing a new delivery system.

Reduced federal costs may result from eliminating federal payments to originating lenders and financing loans with low-cost Treasury financing. Removing originating lenders would eliminate their current federal SAP as well as the need to pay the in-school interest subsidy. Separating loan origination from the rest of the student loan process may enable the federal government to take advantage of any savings because of greater specialization in student loan origination. An entity responsible solely for student loan origination would not have to be concerned with raising necessary funds competitively or with servicing loans efficiently. However, removing competition from loan origination could eliminate existing incentives to continuously improve the efficiency of the origination process.

Further federal savings could accrue if loan sales foster competition in the secondary market for loans, but savings would depend in part on auction design decisions. Ideally, competitive bidding for loans among secondary market lenders would result in loans being held and serviced by those with the lowest cost of funds and the most cost efficient at servicing loans. Increasing concentration in the existing secondary market for student loans raises questions about the extent to which competition will operate in loan sales and the extent to which potential cost savings will accrue to the federal government. If auctions are not sufficiently competitive, then increased lender net yield could result, potentially reducing federal revenues from the sales and thereby increasing federal FFELP costs. Although sufficiently competitive auctions could reduce net lender yield, their overall effect on FFELP costs would also depend on details of the auction

design. The frequency with which auctions were held, the choice of bidding method, and the definition and grouping of auctionable packages could either lower or increase FFELP costs.

The terms of the sale will affect the price that bidders will pay for loans in an auction. Lenders will bid more for loans that are sold with a guarantee.[27] The net effect on federal costs would then depend on a comparison of the additional revenue raised by guaranteeing loans to the federal cost of providing a guarantee. Also, federal costs could depend on whether winning bids are payable in full immediately after the close of the auction or whether a schedule of installment payments is allowed. Allowing installment payments extends federal funding to secondary market participants, possibly enabling small bidders to participate more easily. Small bidders would have to come up only with a down payment rather than with the full purchase price, enabling bidders with less funding to compete with better-funded large bidders. However, allowing loan purchasers to pay in installments could result in new risks and potential costs. The most significant of these risks would be that lenders obtaining federal funding might be unable to repay the money they borrow from the government. Several considerations might mitigate this risk. For example, lenders could be made to meet additional criteria, related to financial soundness and creditworthiness, before being allowed to borrow from the federal government. In addition, legislation or regulation could treat the auctioned loans as collateral for the borrowing. The cost of administering an installment payment option would be an additional source of increased federal government costs for FFELP.

Ultimately, borrower costs are unlikely to change much after implementing the sale of loans at auction. At present, some lenders offer origination fee or interest rate discounts off of the maximum rate to some borrowers (for example, those who attend schools with low default rates). If lenders are providing discounts from profits, then auctions could eliminate the discounts by reducing those profits. As a result, some borrowers who now receive discounts may no longer receive them. However, if discounts do not come from lenders' profits, then auctions would not eliminate the discounts and would have no effect on borrowers. Furthermore, if auctions reduced federal FFELP costs, the Congress could decide to pass those savings on to borrowers by lowering the maximum borrower interest rate. In that event, all borrowers would benefit from lower interest rates. Other discounts that loanholders currently provide occur after the loan has entered repayment. Lenders have provided these discounts for automatic electronic payment and demonstrated timely payment experience. When timely or electronic repayment result in lower costs to secondary market loan holders, there will continue to be incentives for loan holders to encourage such behavior through discounts. Issues related to competition, auction frequency, auction design, bidding methods, grouping, and payment methods are presented in detail in app. III.

EFFECTS ON LENDER PARTICIPATION, LOAN AVAILABILITY, AND QUALITY OF SERVICE

With loan sales, the federal government or some entity other than private lenders would originate all student loans. Loans would be universally available to all eligible borrowers. Concentration

[27] The budget scoring effects for loans sold with a guarantee are beyond the scope of this report.

in the secondary market would be likely to continue to increase, resulting in reduced diversity of lenders. As lenders focus more on price paid to the government, they may pay less attention to service quality.
In the short term, auctions may have any of several effects on the number of FFELP lenders. They may increase lender participation by enabling new lenders to enter the market on relatively equal terms with existing lenders. It is also possible that auctions would increase large lenders' dominance of the secondary market. Large lenders would have several advantages over small lenders. Because they can usually obtain loan funds more cheaply and can spread their costs over a larger volume of loans, large lenders would generally be able to outbid their smaller competitors. In addition, auctions would necessarily make lenders uncertain about their prospects of continuing to participate in FFELP. This uncertainty may be more likely to deter small lenders than to deter large lenders.

Over the long term, lenders who do not win in one auction might leave FFELP permanently, if they find it expensive to reenter the market. If losing bidders drop out permanently after each auction, then the number of bidders could gradually decline, leading to higher federal costs. However, it is also possible that the losing bidders—especially those participating by holding and servicing loans from prior years—will not leave FFELP. With a loan sale, a participant who has been a winner for 3 years but does not win in year four will probably not leave FFELP, because that lender still has revenue from the previous years' loans. That lender may find it easy to re-enter in the next year, and this may be less of a concern than in the loan origination rights auction model.

One way the Congress could ensure lender diversity and pervasive participation would be to include special provisions, such as installment payment payments, that would protect small bidders' ability to compete. Although small-bidder protections may restrict the ability of larger firms to compete, they may also improve the overall competitiveness of the market. Another way of promoting competition in auctions is to adopt rules to ensure that all bidders are able to pay the amounts they bid. Without such rules, non serious bidders could distort the auction results by placing bids that were unrelated to their valuations of the rights. Details of auction provisions regarding these features are presented in app. III.

Loan sale auctions may affect the service quality of loan origination. In some models, such sales could remove competition from loan origination and could eliminate existing incentives to continuously improve the efficiency of the origination process. A single originating lender may not feel competitive pressure and therefore might be less likely to introduce new and innovative loan options.

There is some concern that auctions could shift the nature of competition in the student loan market toward price competition and away from service quality competition. At present, FFELP lenders compete to some extent on the basis of price through discounts to preferred borrowers. They also compete to some extent on the basis of service quality. Auctions would force lenders to place more emphasis on price competition, since the major (and, in most variants, the sole) criterion for determining auction winners would be the price bid. It is possible, although not

certain, that lenders would pay less attention to service quality as they paid more attention to price.[28]

SIMPLICITY, REGULATORY BURDEN, AND PROGRAM INTEGRITY

Loan sales could simplify the origination process for borrowers and schools by centralizing the origination and distribution of all loans. Some transitional challenges could be anticipated and thus lessened through the use of a pilot program. Lenders choosing to continue their FFELP participation would face an adjustment period during which they would need to learn how to participate in auction sales. While the integrity of the student loan program is not expected to suffer, auctions would require the federal government to establish special rules to preserve competition.

Loan sales could extend the origination and distribution channels already in use by FDLP. Borrowers and schools would no longer be able to choose a lender. This change would require adjustments in the short run by schools not currently participating in FDLP. Since required transitions primarily affect loans entering repayment, the effect on student borrowers should be minimal. It is possible that the current distinction between FFELP and FDLP would be eliminated if all loans were sold at auction.

Lenders who continue in the program would need to learn how to participate in the new program. Regardless of the way auctions are designed, they require participating lenders to develop skills and procedures that they do not currently have. Initially, lenders would need to make decisions without experience as a guide. In addition, the federal government could identify some potential logistical problems during the transition by conducting a pilot program before implementing a loan sales system for all FFELP loans. Using knowledge gained from the pilot program, it could then take steps to lessen those problems.

The government would have to adopt and enforce regulations to maintain competition in bidding and ensure that participating lenders were creditworthy. Rules to prevent bidders from colluding would be necessary, especially if the trend toward increased secondary market concentration continues. The nature and complexity of these rules would depend on the types of collusion to which a particular type of auction could be vulnerable.

Operating and administering a loan sales program require additional federal data collection. An installment payment option tied to borrower repayments would require tracking the payments received by participating lenders from borrowers and matching this information to lender installment payments. As previously discussed, obtaining and using accurate data are critical to

[28] Service quality could be higher if multiple servicers were allowed than if there were only one servicer choice. If students have the opportunity to select servicers or to choose a lender for consolidating loans, servicing lenders would have an incentive to compete for students on the basis of service quality. A proposed borrower web interface would better inform borrowers of their repayment options, where and to whom to send their payments, and other related matters. This could serve to limit or reduce delinquency and reduce servicing issues.

effectively managing the program. Results of the analysis for the loan sale model are summarized at a broad level in table 11.

Table 11: Summary of Analysis for Loan Sale Model

Description of model, including variations	• The government or a government-designated entity originates loans. • Private entities bid to purchase packages of loans, either after origination or upon borrower's graduation. • Loans could be sold with or without a guarantee. • Purchase could be paid up front or financed and paid over time.
Costs, savings, and effects on subsidies for program participants	• Federal costs could be lower; effect would depend on how loans are packaged. • No federal payment would be made to originating lenders. • Federal payments to guaranty agencies could be reduced or delayed. • Borrower costs unaffected.
Effects on lender participation, loan availability, and quality of service	• Loans would be available to all. • The concentration of loanholders could increase. • Schools could serve as loan originators. • The quality of service in repayment could decline.
Simplicity, regulatory burden, and program integrity	• Simple for borrowers; federal role more complex. • Continuing lenders must learn auction mechanism. • Program integrity is not expected to suffer.

CHAPTER 5
FEDERAL FUNDING

The federal funding model would give lenders the opportunity to borrow funds from the federal government with which to make FFELP loans. Borrowing could be provided as an option to lenders or could be made mandatory for lender participation in FFELP. Lenders would be required to bid on the interest rate they would pay to the government for the use of federal funds. The total amount of federal funds available to FFELP lenders would be limited. Lender yield would be set legislatively and could be the same as the maximum borrower interest rate, which is currently based on Treasury rates. This model would affect lenders' cost of funds rather than the lender yield. Federal costs could increase, decrease, or remain the same. Some roles of FFELP participants could change, depending on how the model is implemented, including major changes for the role of lenders. The model could also potentially affect the ability of schools and students to work with lenders of their choice as well as the availability of loans and the quality of service to borrowers.

DESCRIPTION OF MODEL, INCLUDING VARIATIONS

In the federal funding model, the federal government would auction to lenders a predetermined volume of federal funds set aside for lenders to use to make FFELP loans. Each bid would include an interest rate and the volume the bidder desired to borrow at that interest rate. The interest rate at which each winning lender borrowed, in conjunction with a legislatively set lender yield that could be equal to the FFELP maximum borrower interest rate, would determine that lender's net yield. Borrowing from the federal government could be made mandatory for lenders who want to participate in FFELP, or it could be offered as an option, with lenders still being allowed to fund student loans through traditional methods. Finally, lenders could repay the funds they borrowed from the government on either a regular amortization schedule or a schedule tied to borrower repayments on the FFELP loans made with the federal funds.

Basic Model and Roles of Participants

The federal government would estimate the volume of loans that students will demand in a given year. Lenders would submit one or more bids for a portion of the total volume. For example, a lender could bid for a certain volume at one interest rate, then additional volume at a different rate, for as many different rates as desired. The agency operating the bidding system would collect all bids, sort the interest rates from high to low, and total the volume that all bidders desired at each interest rate. The interest rate emerging from the auction would be the lowest bid interest rate at which the sum of the desired volumes just exhausted the volume of federal funds being allocated. All lenders whose bids were above or equal to this rate would receive the allocation they bid. To prevent any one lender from gaining an unacceptably large share of the FFELP market, the government might limit the volume of federal funds that any lender could receive.

As in the current FFELP, the Congress would continue to set the maximum borrower interest rate. The reference rate for the maximum borrower interest rate (and the lender yield) could be any interest rate. However, because lenders would be likely to borrow from the government at Treasury-based rates (that is, at rates that are markups over the interest rate paid on a Treasury debt instrument), the Congress might consider keeping the maximum borrower rate Treasury-based as well and changing the lender yield back to a Treasury-based rate. This rate could change from the 91-day rate to a longer-term rate if desired. By giving lenders a Treasury-based source of funds, this model could allow the borrower rate to remain Treasury-based and give lenders the ability to match-fund.[29]

The bidding is likely to be based on the same Treasury rate as is the basis for the maximum borrower interest rate, to eliminate concerns about basis risk.[30] For example, the relevant Treasury rate could be the 91-day Treasury bill rate or the 10-year Treasury bond rate. The interest rate for bidding could then be expressed as a specified number of percentage points above or below the Treasury rate.[31]

The lender yield for FFELP loans would continue to be set legislatively. One option is for the Congress to set the lender yield equal to the maximum FFELP borrower interest rate so that the government makes no SAP.[32] Lenders' net yield, which depends on the difference between the legislatively set yield and their funding and operations costs, would be affected in this model by changes to funding costs.

To ensure that loans were available to students, lenders who won at auction would be required to use the entire volume they borrowed from the government to originate FFELP loans. Lenders would be required to return the unused portion of funds borrowed. To avoid having the government lend more funds than necessary, requiring a process to accommodate the return of funds, lenders could apply for federal funds after originating the FFELP loans. Otherwise, the government would need to match the timing of lender borrowing and payment to the corresponding student loan disbursements and repayments.

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[29] "Match funding" refers to lenders matching the basis of the interest rate at which they borrow to finance a loan with the basis of the interest rate that they receive from the loan. If they are able to do so, then changes in the interest rate affect their costs and revenues identically and do not affect their net profits. If their funding costs and their revenues are based on different interest rates and those rates do not move in tandem, then their net profits could fluctuate.

[30] Basis risk is the risk created by a mismatch between the interest rate at which an entity borrows and the rate at which it lends. For example, borrowing at a commercial paper-based rate and making loans at a Treasury-based rate introduces risk because, if the commercial paper rate were to rise relative to the Treasury rate, borrowing costs would rise relative to income from the loans. This would reduce profits.

[31] Another option would be to establish a borrowing rate and then conduct bidding in terms of the price that lenders are willing to pay to borrow at that rate rather than bidding on the rate directly. For example, the rate could be set at the maximum borrower rate plus a small markup, and lenders could bid a dollar amount for the right to borrow a certain volume of federal funds at that rate. Lenders willing to pay the most would win the right, and enough winners would be selected to exhaust the volume that was put up for auction.

[32] The government would presumably still pay lenders a SAP if the borrower rate were high enough to hit its cap.

In other respects, this model would leave the roles of FFELP participants unchanged. In addition, FDLP could remain as it is today, with terms for students the same as in FFELP.

Major Variations on the Model

Participation in this system could be made optional or mandatory for FFELP lenders. Lenders could be offered the option of borrowing from the federal government or funding their FFELP loans and competing as they do now. The lender yield would have to be sufficiently high that nonparticipation was a realistic option and non participants could make a reasonable profit. If the lender yield were too low, participation would effectively become mandatory rather than optional. Alternatively, participation could be made mandatory so that only lenders who took part in this borrowing would be allowed to make FFELP loans.

The volume of federal funds that the government would have to make available at auction would depend on whether federal funding were mandatory or optional for lenders. If lenders were required to use federal funds for FFELP loans, or if federal funding were effectively mandatory even though optional in principle, then the government would have to set aside enough funds to meet the loan volume that it expected students to need. If lenders' use of federal funding were truly voluntary, then the government would have to set aside less than the total loan volume expected to be needed.

Auction design details, such as the choice of bidding method, could affect the results. These design issues are common to all the auction models discussed in this report. For further details on auction design issues, see app. III.

COSTS, SAVINGS, AND EFFECTS ON SUBSIDIES FOR PROGRAM PARTICIPANTS

Federal FFELP costs under this proposal could increase, decrease, or remain the same. Federal FFELP costs could decline as a result of a bidding process if auctions were sufficiently competitive. The frequency with which auctions were held and the choice of bidding methods could also affect federal FFELP costs. (See app. III for an explanation of these issues.) However, the federal government would also face new risks and potential costs in a federal funding model. The most significant of these risks would be that lenders obtaining federal funding might be unable to repay the money they borrowed from the government, although the likelihood of this might be quite low. This risk could be mitigated by requiring lenders to meet certain criteria for borrowing federal funds. The cost of distributing funds to lenders and of collecting repayments from lenders would be an additional source of increased federal government costs for FFELP. Some of this cost increase might be recovered by reducing or eliminating the SAP.[33]

[33] Currently, if due diligence regulations are not followed or something else threatens the guarantee, one recourse that Education has now is to withhold SAP payments to the lender. If the SAP were eliminated, the government might have less leverage over the lender.

In addition, the federal government could face conflicting incentives in the guarantee process. If the federal government is both reinsuring student loans and providing funds for them, then strict enforcement of due diligence rules could create a loss risk for the government. For example, if an FFELP loan loses its guarantee because of improper servicing, the lender might have difficulty repaying a portion of the funds it borrowed from the government. If the guarantee were maintained, the lender would receive the insurance payment for the defaulted loan and would then have funds available to repay the government. In effect, the government could be seen as guaranteeing its own loans. However, the federal guarantee could operate in different ways. Rather than paying a default claim, the government could simply reduce the amount that the lender owes by the amount of the default. Or, if a student defaults, the guaranty agency might pay the government directly (with that portion of the lender's debt to the government being erased) rather than the guaranty agency's paying the lender.

This model would change net yield for lenders by determining their funding costs rather than affecting lender yield. Net yield depends on lender yield and costs, such as funding and operating costs. Most of the market mechanism models use the mechanism to explicitly set the lender yield, but this model uses it to set one portion of costs. Either approach ultimately has an effect on net yield.

Costs could decline for lenders who used federal funds. If these federal funds bear a low enough interest rate, then lenders' costs could decrease and their net yield could increase. Additionally, if the model gives lenders a source of funds tied to Treasury rates, potentially allowing lenders to match their revenues from FFELP loans, lenders would not bear the costs of interest rate mismatches. Lender costs could be lowered as lenders gained the ability to match the movement in their cost of funds to the movement in the lender yield. As noted, both would be likely to be based on Treasury rates, so lenders would face no basis risk.

If lenders were not required to use federal funds to originate FFELP loans, then participating lenders might be forced effectively to give up all or some of the savings they realized in order to make competitive bids. This could, in turn, affect discounts offered to borrowers. Participating lenders' costs might remain unchanged or decline. Therefore, those lenders' profits might remain unchanged or increase.

If lenders were required to use federal funds to originate FFELP loans, then lenders might be forced to give up all or some of the savings they realized, or even more than the amount of those savings, to make competitive bids. This could also affect discounts to borrowers. Lenders' costs could increase, remain unchanged, or decrease. Lenders' profits could, therefore, decline, remain unchanged, or rise.

An implicit subsidy to borrowing lenders would be present if lenders had the use of federal funds before to student loan disbursements and after loan repayments by student borrowers.

EFFECTS ON LENDER PARTICIPATION, LOAN AVAILABILITY, AND QUALITY OF SERVICE

This model could potentially to reduce the diversity of lenders, particularly if lenders were required to use federal funding to originate FFELP loans. Additionally, the relationships among FFELP participants could substantially change. The effects of federal funding on loan availability would depend on whether lenders' use of federal funding were optional or mandatory and on whether and sufficient federal funding were available. The quality of service could decline if federal funding were mandatory for FFELP.

If lenders using this process secured significant funding cost advantages relative to other lenders, and if other aspects of FFELP remained competitive, then over time competition could squeeze out non participating lenders or force them to participate. Lenders with different costs of funds, such as those who have access to tax-exempt funding compared with those who do not have access to it, would be affected differently. The process might effectively become mandatory to ensure profitability, at least for certain types of lenders, and the number and diversity of lenders could decrease.

Like origination rights auctions, federal funding auctions can reduce the participation of small lenders in FFELP, especially if the use of federal funding is mandatory. Small lenders, who usually cannot borrow funds in the private market at rates as low as those paid by large lenders, might not be able to bid as high for federal funds as large lenders could. If maintaining a large number of lenders or a diversity of lender types is desired, certain design features could be built into the model. App. III describes these options.

Several questions remain about lenders' relationships to the federal government. The process might be seen as reducing lenders' role to that of a contractor for a system that appeared similar to FDLP. In contrast, lenders would own the loans they originate, and they would still compete on price and service quality after getting their funding. A further consideration is whether, after a change from private to federal funding for FFELP, private sector funding could be brought back easily if it were deemed necessary.

The effects of federal funding on loan availability would depend on whether lenders' use of federal funding were optional or mandatory and on whether sufficient federal funding were available. If federal funding were mandatory and the volume of federal funds auctioned were insufficient to meet student needs, then loan availability would be reduced. If federal funding were mandatory but the federal government auctioned a sufficient volume of funds to meet student needs, then some students might have temporary difficulty finding a lender who had federal funds available from which to lend, but permanent effects on loan availability would be unlikely. If federal funding were optional, then loan availability might be less likely to be affected because FFELP lenders would have access to alternative sources of funds.

Under this model, quality of service might decline or remain unchanged. If a particular lender did not win any federal funding in a particular year (or even a longer time period),

then the borrowers and schools that were accustomed to dealing with that lender would have to go to other lenders during that year. Borrowers might have more difficulty meeting their repayment obligations if they had to deal with multiple lenders than if they could each deal with a single lender. Some borrowers might be more inclined to consolidate their loans rather than deal with multiple lenders. In addition, schools could lose the ability to work with non winning lenders and could be required to adapt their information technology systems and student financial aid procedures to accommodate winning bidders. These concerns, including fixed investments in computer technologies specific to particular lenders, could be important for high-quality service to schools.

SIMPLICITY, REGULATORY BURDEN, AND PROGRAM INTEGRITY

Bidding on the interest rate lenders would pay the federal government would require its own set of administrative decisions and a regulatory framework for how the bidding process would be conducted. If criteria for lender participation in the auction were established, beyond criteria that lenders must currently meet to participate in FFELP, these would add to administrative burden. As with origination rights auctions, lenders could face difficulties during the transition to federal funding, and both the transition and the timing of auctions could affect the availability of loans to student borrowers. Some transitional challenges could be anticipated and thus lessened through the use of a pilot program.

Operating and administering a federal funding program would create additional data collection needs. The government would need to keep track of the funds borrowed by participating lenders and match lender draw-downs to the timing of student loan disbursements and match lender loan payments to loan repayments by student borrowers. As mentioned previously, collecting sufficient and accurate data is key to managing the program and reducing the risk of loss of government funds. Executive agencies have expressed concern about the federal funding model. In addition, the federal government could identify some potential logistical problems during the transition by conducting a pilot program before implementing a federal funding system for all FFELP loans. Using knowledge gained from the pilot program, it could then take steps to lessen those problems. The results of the analysis for the federal funding model are summarized at a broad level in table 12.

Table 12: Summary of Analysis for Federal Funding Model

Description of model, including variations	• Lenders would borrow funds from the federal government to make FFELP loans. • The process could be made optional or mandatory for FFELP participation. • Lenders would be charged an interest rate determined through a bidding process.
Costs, savings, and effects on subsidies for program participants	• Federal FFELP costs could increase, decrease, or remain the same. • Funds borrowed from the federal government might not be repaid. • Lenders could potentially eliminate risks from interest rate mismatches.
Effects on lender participation, loan availability, and quality of service	• If federal funding were optional, lenders could continue to participate in FFELP and not change behavior. • If participating lenders secured significant cost funding advantages, all lenders might have to use federal funding, and lender diversity might eventually decline. • Loan availability should not be threatened if sufficient federal funds are made available. • Service quality could decline or remain unchanged.
Simplicity, regulatory burden, and program integrity	• Regulations would be required to govern the bidding process. • Additional requirements might be possible for lenders to be allowed to participate in auctions.

CHAPTER 6
MARKET-SET RATES

A FFELP guaranteed student loan program with market-set borrower and lender interest rates would use competition to determine the interest rates and other terms and conditions of student loans. The primary distinguishing feature of this model is that the borrower rate, as well as the lender yield, would be determined in the marketplace and rates could vary across borrowers and lenders. Student borrowers, or schools, would shop for the most favorable loans. Lenders would charge the interest rates that borrowers agree to pay. Other possible changes might include no legislatively mandated rate ceiling for borrowers, no federal subsidies to lenders, and no federal payment of interest while borrowers were in school. Because of this, federal costs would be likely to decline in a simple version of the model. Lenders could tailor interest rates and other loan features to the needs of different students at different schools. Competition might lead lenders to offer different loan packages to different students on the basis of lenders' perceptions of risks and costs. Because a federal guarantee on student loans would remain, the range of rates might not be exceptionally wide. In addition, the increased competition might induce improvements in loan origination and processing that could improve the delivery system for both schools and students. Some study group members believe all students should receive a comparable interest rate set by the Congress. Allowing the market to set the rate has the potential to limit loan access for students with the greatest need. Market-set rates could reduce or eliminate some borrowers' access to loans. However, there are variations to this model that could ameliorate this problem. The market-set rate model would also place a greater burden of adjustment on all FFELP participants than would the other models discussed in this report.

DESCRIPTION OF MODEL, INCLUDING VARIATIONS

In the model described in this chapter, student borrowers, or schools negotiating on their behalf, would shop among lenders for the best available interest rates. Market competition would determine the interest rates lenders would receive, which would be the same as the interest rates borrowers would pay. Particular versions of the model differ according to how, if at all, they limit variation in interest rates among borrowers.

Basic Model and Roles of Participants

Market competition would determine interest rates for both borrowers and lenders. Lenders would charge the interest rates that borrowers agree to pay. The current federal loan guarantee would remain, but the federal government would provide no other subsidies to borrowers or lenders. Lenders could offer different interest rates to different students at different schools on the basis of their evaluations of how default risks and servicing costs differ among students and schools. Students or their representatives would be able to shop among lenders for the best available interest rates, possibly using interest rate information that would become available over the Internet. However, because students are often too inexperienced to shop for loans, schools would be likely to shop on their behalf. In the market, schools would likely be able to negotiate

better interest rates for students and choose a limited set of lenders with whom to conduct business.

Whether the student or the school does the shopping for the loan and loan terms could change the loan terms actually provided the student. It is logically possible that the school will have concerns that do not line up exactly with the interests of the student. For example, ease of administration and support for the school's lending operations may be more important to the school than the student. In contrast, the student may be more interested in the interest rate and the ease of dealing with the lender after graduation.

The current mix of federal and state roles in operating the mechanisms could change. In the simplest version of this approach, the federal government would no longer set the rate ceiling or other terms and conditions of FFELP loans. However, because the federal guarantee would remain, due diligence rules for servicing would still be required, and they would affect loan terms and conditions. The role of the states need not change. State guarantee agencies and secondary markets could continue to function.

The market-set rates model would require student borrowers, or schools acting on their behalf, to be well informed about the characteristics of loans available in the market. Without accurate and timely information, students or schools would be unable to evaluate loans offered to them or negotiate effectively with lenders. Schools or students would need information about loan terms offered to all types of students, for all types of schools, and in all regions of the country. With such data available, students and schools could compare their loan offers and rates with offers and rates made in other circumstances. These comparisons would not eliminate all rate and service differentials. However, such information would facilitate students or schools shopping for the best deals, given current conditions in the market.

Major Variations on the Model

The extent to which interest rates vary among borrowers could be limited in several ways, or it might not be limited at all. One option would be to allow market competition to determine interest rates without any restriction on the rates that lenders could charge. If the Congress believed that this option was unacceptable because it would make loans unaffordable for some borrowers, resulting in unacceptably high average borrower interest rates, or produce too much variation in borrower interest rates, then it could choose one of three methods of limiting variation in borrower rates. It could

- designate a lender of last resort,
- limit the extent to which a lender could offer different rates to borrowers presenting similar risks and costs, or
- provide an interest rate subsidy to all FFELP borrowers, which need not be constant.

The federal government could serve as a lender of last resort, using either FDLP or a newly established lending program. Alternatively, the federal government could pay a private lender or

lenders to do so. (The private lender or lenders would have to be paid because the lenders would presumably not otherwise lend at the designated rate.) The Congress would need to determine the interest rate that the lender of last resort would be allowed to charge, decide on the compensation to be paid to the lender of last resort, and set criteria for borrowers to be eligible to borrow from the lender of last resort.

Another option would be to limit variation in the interest rate or origination fees that a lender could offer to a group of borrowers. The federal government could define groups of borrowers by student or school characteristics that are associated with varying levels of servicing cost or default risk. For example, borrower groups could be based on average loan balances, type of degree sought, or type of school attended. The federal government would limit the interest rate or origination fee differences that would be allowed within each group but would not restrict these differences between groups. FHA imposes this type of limitation on the variation in "mortgage charge rates," analogous to FFELP origination fees, among recipients of the home mortgages it guarantees. Market competition determines the interest rates and fees on FHA-guaranteed mortgages, and different borrowers pay different rates and fees. However, FHA divides mortgages into groups on the basis of location and characteristics affecting prices and charges, such as fees or costs. FHA limits the difference between the highest and lowest mortgage charge rate within a group in any time period to 2 percentage points.

A final option would limit the rate level by setting a federal subsidy for borrowers for all FFELP loans. Such a subsidy would lower the interest rate for all borrowers by the same number of percentage points. It would also preserve borrowers' incentive to shop for the lowest interest rates, since a borrower would always benefit if he or she could find a lower rate. Furthermore, this subsidy could be uniform for all borrowers or could vary by the same student or school characteristics - average loan balances, type of degree sought, or type of school attended - as designated above. For example, borrowers in short-term programs or schools with high default rates, who might face the highest rates in the marketplace, could receive larger subsidies than those in other programs or schools, to try to ensure a more uniform rate for all borrowers.

COSTS, SAVINGS, AND EFFECTS ON SUBSIDIES FOR PROGRAM PARTICIPANTS

Market-set rates are likely to reduce federal costs in the simplest version of the model, in which government payments to lenders would be eliminated. Subsidies to borrowers would be reduced in most versions of the model. Average borrower interest rates would probably rise in the short run but could increase, decrease, or remain unchanged in the long run. However, interest rates are likely to vary more among borrowers than they do today, increasing for some borrowers and possibly declining for others; thus, federal cost savings might come at the expense of borrowers who pay higher rates, potentially making some schools unaffordable for some borrowers. Lower initial interest rates for the lowest-cost, lowest-risk borrowers might replace the discounts that some lenders currently offer to those borrowers. A shift to market-set borrower interest rates in FFELP would also be likely to necessitate a change in the method by which FDLP interest rates were determined.

In the simple version of the model, federal FFELP costs under a system of market-set rates are likely to be lower than they are now. Federal costs include the cost of the federal loan guarantee, payment of interest while borrowers are in school (for subsidized Stafford loans), and payments to lenders to cover the difference between the lender interest rate and the maximum borrower rate. By eliminating the federal government's payments of in-school interest and its payments to lenders, the market-set rate model would lower federal FFELP costs. (The cost of the loan guarantee would not change, assuming that the guarantee structure did not change and that these program changes did not affect default rates.) If the federal government had to serve as lender of last resort or pay private lenders to do so, or subsidize borrowers, then it would incur extra costs, which would reduce or eliminate the federal savings from switching to market-set rates. If the federal subsidies or lender-of-last-resort costs were great enough, federal costs for FFELP could increase.

Market-set rates would eliminate all federal payments to lenders in the simplest version of the model. Under most options, there would be no federal subsidies to borrowers. Subsidies to borrowers would continue to exist only if the federal government chose to limit differences in borrower interest rates, or reduce the rates for all borrowers, by paying a subsidy to all borrowers. Eliminating the rate cap or making it less binding for all borrowers would be a major change in federal policy, which historically has set the same rate cap for all borrowers.

In the short run, the interest rates that borrowers pay, on average, would be likely to be higher than they now pay. In the long run, the average borrower rate could be higher than, lower than, or the same as at present. In the simplest version of the model, in the short run, eliminating the federal cap on borrower interest rates and federal subsidies to lenders would probably cause the average borrower rate to rise. In variants of the model that included methods of limiting borrower interest rates, borrower rates could increase by a lesser amount, or remain unchanged, in the short run. However, the long-run effect on borrower rates in any version of the model would depend on whether lender participation in FFELP increased or decreased. If lenders' freedom to set interest rates induced entry by new lenders and increased participation by current lenders, then those rates might fall. If some current lenders exited the FFELP and no new ones entered, then borrower rates could increase.

Market-set rates would probably increase the variation in the interest rates different borrowers pay, raising some borrowers' rates while lowering others'. The increase in variation may not be large, however, since the federal government would still guarantee 98 percent of the principal of each loan. Currently, the legislatively set borrower interest rate cap limits the amount of variation in borrower rates. The market-set rate model would allow some borrowers' rates to exceed the current ceiling. Borrowers that lenders perceived as having high servicing costs or high default risks (for example, those who had low loan balances or who attended schools with high student loan default rates) could face higher rates. These borrowers could end up paying interest rates exceeding the current ceiling. In the long run, interest rates for borrowers with low servicing costs or low default risks could decrease, if market competition eventually caused their average borrower rate to fall. In that event, low-cost, low-risk borrowers, who now receive discounts that give them interest rates below the ceiling, could pay even less.

Low-cost, low-risk borrowers might pay lower up-front interest rates instead of receiving discounts. Currently, lenders often give those borrowers interest-rate discounts after repayment begins. With increased competition at the front end of the loan, lenders might offer those borrowers lower contractual interest rates, leaving less flexibility for rate discounts during repayment. However, lenders might still offer discounts for good performance or for automatic electronic payment if offering those discounts increased profits for lenders.

In addition to affecting FFELP borrower interest rates, a system of market-set rates would probably require a change in the method of setting borrower interest rates in FDLP. Currently, FDLP rates are based on FFELP borrower rates. If FFELP borrower rates were determined through market competition, then they would probably vary more across borrowers and over shorter periods of time than they do now. It would become more difficult to base FDLP rates on FFELP borrower rates because of the increased variation in the latter. It would be possible to set FDLP rates on the basis of an average of FFELP borrower rates over a designated period of time. However, this approach would require Education to collect large amounts of data on FFELP borrower rates, decide which borrower rates would be included in the average and how the average would be calculated, and determine the time periods for which it would collect the data.[34] Alternatively, the Congress could set an FDLP interest rate independently of FFELP borrower rates. This option, however, would be likely to make determining FDLP interest rates at least partially a political decision and potentially set a ceiling for FFELP loans.

EFFECTS ON LENDER PARTICIPATION, LOAN AVAILABILITY, AND QUALITY OF SERVICE

Market-set rates could give lenders a continuing incentive to reduce their costs. If student loan markets are somewhat competitive, lower-cost lenders can offer lower rates and increase their market shares and profits. In addition, lenders setting higher rates will lose customers unless they are providing superior levels of service and other loan features attractive to borrowers. They might reduce the quality of service or leave it unchanged but might have less incentive to improve it than in the current system. Effects on lender diversity are uncertain. Some borrowers would be likely to lose access to FFELP. This problem would be somewhat mitigated if there were a lender of last resort. During a transition period, some borrowers who would ultimately have access to FFELP loans could be temporarily unable to obtain them, while other borrowers who would ultimately lose access might be able to borrow under FFELP.

Lenders' costs would also be likely to continue to decline after a market-set rate system was put in place. If lenders had to compete for business from students or schools that wanted to obtain low interest rates, then they would face a continuing incentive to cut interest rates. To cut interest rates and maintain a sufficient profit to make it worthwhile for them to remain in FFELP, lenders would have to reduce their financing, origination, or servicing costs. Because any lender who could gain a cost advantage over competitors would gain borrowers at their expense, all lenders would be under continuing pressure to reduce their costs.

[34] The method chosen for setting the direct loan rate would also affect budget scoring for both programs.

Market-set rates might reduce service quality or have no effect on it. The balance of competition in the student loan market might shift toward price competition and away from service quality competition. At present, FFELP lenders compete to a limited extent on the basis of price, through discounts to preferred borrowers. They also compete on the basis of service quality. Under market-set rates, lenders might place more emphasis on price competition. It is possible, although not certain, that lenders would decrease their emphasis on service quality as they paid more attention to price.

It is also possible, although not certain, that market-set rates would reduce service quality by weakening long-term relationships between lenders and schools. At present, schools maintain lists of "preferred lenders." Financial aid officers become knowledgeable about the practices of those lenders. Some schools' computer systems are programmed to deal with lenders on their preferred lists. Since schools often serve as intermediaries between lenders and students, school-lender relationships can improve service quality if they help schools assist students in dealing with lenders. In a system of market-set rates, schools might choose lenders on the basis of price and sacrifice these long-term relationships with lenders. If students chose lenders directly, they might not choose the lenders with which their schools previously had ongoing relationships. However, it is also possible that students and schools would see value in lender-school relationships and be unwilling to sacrifice these relationships to obtain slightly lower interest rates.

The effect of market-set rates on lender diversity is uncertain. If lenders' freedom to set interest rates attracted new lenders into FFELP in the long run, then lender diversity could increase. Alternatively, with increased price competition, large lenders who could invest in the human capital and servicing systems that would enable them to offer the low interest rates might drive other lenders out of FFELP and prevent new lenders from entering the program. Similarly, secondary market lenders could be affected, if competition drove less efficient lenders and secondary markets out of the market via mergers. However, consolidations of lenders and secondary markets are already occurring in FFELP. It is possible that those consolidations would continue under a system of market-set rates and that market-set rates would have no effect on them.

Without a lender of last resort or a substantial federal interest rate subsidy, some borrowers could be priced out of the FFELP market. In a system of market-set rates, lenders would face incentives to charge high interest rates to borrowers they saw as having high risks of default or high servicing costs. For example, they would be likely to charge high rates to students in low-income regions, those from low-income families, and those attending proprietary vocational schools. Lenders would be likely to consider those kinds of students as presenting especially high default risks. Similarly, they might offer higher rates to borrowers in short-term programs or schools at which they are unlikely to end up with high loan balances, such as community colleges. Since loan servicing costs are relatively fixed, borrowers with low loan balances are more expensive to service on a per-dollar basis. If the interest rates that lenders were willing to offer some students were so high that those students were unwilling to pay them, then those students would not be able to obtain FFELP loans. Although the federal loan guarantee would reduce the extent to which different students posed different risks to lenders, it might not be

sufficient to prevent some students from losing access to FFELP. A lender of last resort or a substantial federal subsidy could eliminate this access problem.[35]

During a transition to market-set rates, access to FFELP loans could be reduced from its current level but might differ from what it would be after lenders, schools, and students adjusted to the new rate-setting system. Because lenders would charge the highest-risk and highest-cost students rates that those students might not be willing to pay, those students could lose access to loans. However, differences in interest rates and student access during a transition period need not be the same as those that would ultimately exist in a system of market-set rates. Students, or schools acting on behalf of students, might need time to develop expertise at shopping for low interest rates. During a transition period, their lack of expertise might keep rates higher than they would ultimately be, and some students could initially be priced out of FFELP. Lenders would also need time to develop expertise in assessing the risks and costs of lending to different kinds of students. The criteria they initially used to determine interest rate offers might not be the same as those they would later use. Therefore, some students could be priced out of FFELP during a transition period but regain access to the program later. Likewise, some students who were able to obtain loans during the transition might later be priced out of the program. A lender of last resort or substantial federal subsidy could eliminate access problems that arose during the transition.

SIMPLICITY, REGULATORY BURDEN, AND PROGRAM INTEGRITY

The elimination of most existing program regulations dealing with interest rates charged borrowers would likely simplify FFELP for lenders but place additional burdens on borrowers and schools, and new regulations could make the program more complex for all participants.[36] The extent to which regulations become more complex or simpler will depend on program design features dealing with the exact extent of interest rate variability permitted and the extent to which borrower protection on servicing remain in place. In the simplest version of this model, the federal government would no longer set maximum borrower interest rates, pay interest while borrowers were in school, or pay subsidies to lenders. Eliminating these features of FFELP would probably make the program simpler for lenders. However, borrowers and schools would find the program more complex because they would have to shop for loans. In addition, the loss of access to loans, if it occurred, could be a burden to some students. Any new regulations to preserve competition in the student loan industry would place a burden on large lenders. New regulations designed to preserve both student access to loans and student or school incentives to shop could place burdens on various program participants. The nature of those burdens depends on the type of regulation. For example, if the program limited the range of rates that a lender was allowed to charge different students, then lenders would face an additional burden. If students had to satisfy a complex set of criteria to be eligible to borrow from a lender of last

[35] Regulations restricting variation in interest rates lenders could charge might not eliminate the problem because lenders might find it unprofitable to lend to the highest-risk or highest-cost students at any rate that the regulations would permit.

[36] Even if regulations dealing with borrower rates were eliminated or modified, regulations dealing with servicing loans could remain unchanged.

resort, then borrowers who had difficulty obtaining loans from other lenders would face an additional burden.

Students, schools, and lenders would all have to adjust to changes in regulations and market practices. The adjustments that would be required are probably greater than those required by the other models discussed in this report. If schools changed their preferred lender lists whenever lenders changed their interest rates, then students could have to deal with multiple lenders, and financial aid officers would have to deal with different lenders each year. This might require financial aid officers to face the confusion and administrative burden of constant changes in procedures and forms that different lenders required. The same results could occur if students rather than schools shopped for lenders. The confusion and difficulties of dealing with multiple lenders and variable interest rates might increase the attractiveness of FDLP to schools. Lenders would have to determine their cost structures and provide mixes of prices and services that keep them attractive to students or schools. Students or schools would have to learn how to shop for lenders. Students might also face difficulties dealing with multiple lenders. Guaranty agencies would have to deal with more lenders per student than they do now. Finally, the procedures for consolidating loans might need to change in order to accommodate the variety of interest rates and terms of FFELP loans. The results of the analysis for the market-set rates model are summarized at a broad level in table 13.

Table 13: Summary of Analysis for Market-Set Rates Model

Description of model, including variations	• Lender and borrower interest rates would be set by market competition. • Borrowers would pay the rates lenders charged, unless model included explicit subsidy for borrowers. • Loans retain a federal guarantee. • Options exist to limit variation in borrower interest rates • Rate cap for students might be eliminated or less binding, representing a major federal policy change.
Costs, savings, and effects on subsidies for program participants	• Federal costs may decline but could rise or remain unchanged under some options. • Costs will likely rise for some borrowers and fall for others. • Average borrower costs would be likely to rise in the short run; long-run effect is uncertain. • Government payments to lenders and borrowers are eliminated or reduced under some options.
Effects on lender participation, loan availability, and quality of service	• Lenders have continuing incentive to reduce costs. • Service quality may decline or remain unchanged. • Effect on lender diversity is uncertain. • Loans would probably not be available to all students and schools and their ability to negotiate may be limited unless ameliorative policies were adopted.
Simplicity, regulatory burden, and program integrity	• All FFELP participants would bear a substantial burden of adjusting to new system. • Borrowers or schools would have a greater burden to shop for loans. • Eliminating some existing regulation would simplify FFELP for lenders but new regulations could burden all FFELP participants.

CHAPTER 7
INCOME-CONTINGENT REPAYMENT

Any of the proposed models for introducing market mechanisms into FFELP could include an ICR option or requirement. Under ICR, the amount of a borrower's monthly loan repayment varies with income over time. Some borrowers with low post graduation incomes or high debt levels would make lower monthly payments with ICR than with other loan repayment options.

ICR DESIGN ISSUES COMMON TO MODELS

ICR design issues common to all market mechanism models include how borrowers' repayment terms should be determined, whether the federal government or private lenders should hold ICR loans, who should be able to choose or require ICR, and how borrowers' incomes should be verified.

Repayment Terms Under the Current FDLP ICR Plan and Alternatives

Any ICR plan must specify how a borrower's loan repayments are to be determined. Under the ICR option that now exists in FDLP, loan repayments depend in a complex way on income and other factors. Some borrowers may have portions of their principal or interest forgiven. The examples of other countries that use ICR illustrate alternative methods of determining repayment obligations in an ICR system.

In FDLP, borrowers may choose an ICR option under which monthly payments depend on income and, for some borrowers, loan principal and interest rate and marital status. Under this option, the borrower's monthly payment is the smaller of two amounts: (1) the amount the borrower would repay annually over 12 years in the absence of ICR, multiplied by an income percentage factor based on the borrower's and spouse's adjusted gross income and marital status, or (2) 20 percent of the borrower's income in excess of the poverty level. The ICR repayment obligation is recalculated each year to reflect changes in the interest rate, income percentage factor, and poverty level. App. IV explains the repayment formula in more detail.

Under FDLP's ICR plan, the federal government subsidizes some borrowers by forgiving part of their principal or interest payments. Two kinds of subsidies are available to ICR borrowers in addition to those available to Stafford borrowers in general. First, if the borrower's monthly payment is less than the monthly interest accrued on the borrower's loans, then the unpaid interest is capitalized up to a limit of 10 percent of the original principal balance on each individual loan. The federal government writes off any unpaid interest that exceeds this limit. Second, the federal government forgives any unpaid loan balance remaining after 25 years in repayment. This forgiveness includes any remaining unpaid principal, unpaid interest, or charges on the borrower's loans.

Other countries that use ICR in their student loan systems illustrate alternatives to the FDLP method of determining ICR repayment obligations. For example, some countries have income thresholds below which loan borrowers are not required to make any repayments. Once the borrower has reached or exceeded the set threshold, payments are determined according a percentage of income, as in Australia, or of income above the threshold, as in New Zealand. In Sweden, payments are simply a percentage of total income, with no threshold. Loan forgiveness provisions vary widely. For example, Sweden forgives all student loan debt that the borrower has not repaid by age 65. New Zealand partially forgives interest payments for certain low-income borrowers. Countries with ICR systems also vary as to whether ICR is voluntary or mandatory. In some countries, such as Sweden, all borrowers use ICR. In New Zealand, ICR is the default option but borrowers may choose to repay their loans at a faster rate than required under ICR. In Australia, students indicate whether they wish to use ICR or pay their entire obligation up front. Numerous and significant differences between loan programs run by other nations make the relevance of these program features debatable.

ICR Loans Held by the Federal Government or Private Lenders

Either the federal government or private lenders could hold ICR loans in FFELP. One option that could be incorporated into all market mechanism proposals is to have the federal government, rather than the FFELP lender, hold the loans of borrowers who have chosen the ICR plan. For example, the government could buy at face value ("par") all privately held loans that were being converted from a conventional repayment plan to ICR. If the federal government initially held all FFELP loans (as would be the case under the loan sale proposal), then it could retain ICR loans and sell only non-ICR loans. In either case, the federal government could use a loan servicing contractor to service loans in the ICR plan. Borrowers could select ICR before or after entering repayment.

Private lenders could hold FFELP ICR loans under any of the market mechanism proposals. If lenders originated all loans, then they could continue to hold them or sell them to other lenders, regardless of whether a borrower chose ICR. If the federal government initially held all FFELP loans, then it could sell both ICR and non-ICR loans to private lenders. Privately held ICR loans raise special issues related to the verification of borrower incomes. Financing subsidies to borrowers could also differ for privately held ICR loans than for publicly held ones. These issues are discussed later in this chapter. An additional option would be for private lenders to hold ICR loans but have them serviced by the government of its contractor.

Borrowers could elect to leave ICR, regardless of whether the federal government or private lenders hold the loans. As with the current ICR program, the option of changing repayment plans could be incorporated into ICR under any of the market mechanism proposals.

Choice or Requirement to Use ICR

In the current FDLP, a standard (non-ICR) repayment schedule is the default option but any borrower may choose to use ICR instead. Under a market mechanism approach, ICR in FFELP

could continue with this freedom of borrower choice. Another possibility would be to allow only delinquent and defaulted borrowers to choose ICR as a last resort. If ICR were limited to delinquent and defaulted borrowers, another option would be to allow the lender to put a loan into ICR status. Alternatively, the federal government could mandate ICR for delinquent or defaulted borrowers, for borrowers whose student loan debts were large in comparison with their incomes, or even for all FFELP borrowers. A final possibility would be to make ICR the default option for all FFELP borrowers but to allow borrowers who did not desire ICR to choose a standard repayment schedule.

Income Verification

Regardless of whether the federal government or private lenders held ICR loans, the extent to which the Internal Revenue Service (IRS) should be involved in the verification process is a major policy decision that the Congress would face if ICR were included in FFELP. Income information on borrowers' federal income tax returns filed with the IRS may be more accurate than income information that borrowers supply (such as pay stubs, bank statements, and borrowers' own copies of their tax returns). If borrowers supplied income information to the holders of ICR loans, then some borrowers might under report their incomes, especially if the ICR plan include a future discharge of indebtedness. Even if loan holders required ICR borrowers to present certified copies of their tax returns, fraud could still be an issue. Education's Office of Inspector General found that student aid applicants, even when required to provide a copy of their tax returns as part of the Free Application for Federal Student Aid (FAFSA) verification process, cannot always be relied on to provide accurate information.[37] For these reasons, IRS involvement in the verification process may be desirable. However, IRS has, in general, argued that the use of tax return information for "non-tax collection" purposes undermines public confidence in the tax system and, therefore, reduces voluntary taxpayer compliance with tax laws.

More specific policy decisions about IRS involvement in income verification depend on whether the federal government or private lenders would hold ICR loans under FFELP. If the federal government held the loans, then one possible method of verifying income would be the one currently used in FDLP's ICR plan. In FDLP ICR, two methods of income verification are used: IRS data-matching and borrower-supplied "alternative documentation" of income. Alternative documentation consists of a pay stub, dividend statement, or canceled check or, if none of these is available, a signed statement that explains the borrower's income sources and provides its address. Alternative documentation of income is required for the first year a borrower is in repayment and, for certain borrowers, for the second year. Otherwise, IRS data-matching is used to verify income. App. IV explains the FDLP income-verification procedure in more detail.

If the federal government held FFELP ICR loans and if IRS information were used in verifying borrowers' incomes, then a second policy issue might be whether or how federal contractors

[37] Education, Office of the Inspector General, Accuracy of Student Aid Awards Can Be Improved by Obtaining Income Data from the Internal Revenue Service, ACN: 11-50001 (Washinton, D.C.: Jan. 29, 1997).

involved in administering ICR should be able to obtain information from federal income tax returns. In the current FDLP, contractors handle loan operations, such as origination and servicing. Education requires FDLP ICR borrowers to sign a consent form giving contractors permission to obtain information about their incomes from IRS.[38] Either the Congress (through legislation) or Education and Treasury (through regulation) may wish to consider whether a similar method of borrower consent should be used for ICR in FFELP.

For the current FDLP ICR plan, Education and IRS have devised a system in which consent forms are transmitted to IRS electronically for review. (See app. IV for details.) Education then transmits a tape to IRS containing the items of information to be verified for those taxpayers. Treasury estimates that 100,000 consents are processed under this process each year. Education and Treasury have been working toward a possible statutory or regulatory solution to this paper-intensive approach. The separate consent form is arguably a significant paperwork obstacle to borrowers completing the ICR application process. In addition, the form itself may heighten borrower concern about the federal use of tax return data.

If private lenders held ICR loans, then the main income-verification issue would be whether lenders should be able to obtain borrower income information from IRS or should be required to rely on income information that borrowers supply. As discussed above, borrower-supplied information may be less accurate than IRS information, but IRS has strong reasons to oppose becoming directly involved in income verification for ICR borrowers. Given the long history of discussions between Education and Treasury as well as the Office of Tax Policy's statements at a study group meeting, it seems unlikely that FFELP lenders could ever perform an automated data exchange of tax return information with IRS. Some members of the lending community have suggested that lenders could collect income information from FFELP ICR borrowers and share it annually with Education. Education would then compare the self-reported data with actual IRS tax return data through some type of data exchange to ensure that the self-reported income was accurate within a pre-defined tolerance. The Office of Tax Policy, however, has stated that it does not believe that delegating the IRS data exchange to Education would be lawful. To the extent that Education would ultimately have to disclose all or part of such information to the lender, Treasury would consider this activity to be effectively the same as if lenders were given direct access to confidential tax return information, which is not authorized by federal law. Moreover, Education would require statutory authority to obtain the information from IRS.

ICR VARIATIONS IN THE DIFFERENT MARKET MECHANISM MODELS

ICR could be incorporated into any of the market mechanism proposals discussed in this report. Some features of ICR would vary, depending on the market mechanism proposal chosen. In

[38] The Internal Revenue Code authorizes Treasury to disclose information about FDLP ICR borrowers' identities, tax filing statutes, and adjusted gross incomes to officers and employees of Education for the purpose of determining the appropriate ICR amount (26 U.S.C. 6103(l)(13)). Because Education uses contractors to administer FDLP, these disclosures are made on taxpayer consent forms filed with IRS. Subject to certain limitations, the Internal Revenue Code allows Treasury to disclose a taxpayer's federal income tax return information to any person if the taxpayer requests this disclosure (26 U.S.C. 6103(c)).

particular, the federal acquisition of ICR loans could differ for some market mechanisms, federal payments to private lenders that held ICR loans would exist in only one market mechanism, and any subsidies to ICR borrowers would probably have to be financed differently for different market mechanisms.

Federal Acquisition of ICR Loans

In all the market mechanism models except loan sales, if the Congress decided that the federal government should hold FFELP ICR loans, then the federal government would have to buy from private lenders all loans for which borrowers chose or were required to use ICR. In the loan sale model, in which the federal government would originate all loans and then sell loans to private lenders, it would not auction loans that were designated ICR loans. Under loan sales, if a borrower chose or were required to use ICR after a private lender had bought his or her loan, then the federal government would have to repurchase that loan from the lender.

Federal and Borrower Payments to Private Lenders Holding ICR Loans

Under all the market mechanism models, if private lenders held ICR loans, then lenders would receive the income-contingent payments that borrowers made. In addition, under adjustments to the current system only, they would continue to receive a SAP, based on the difference between the lender yield and the maximum borrower interest rate.

Financing Subsidies to ICR Borrowers

If private lenders held ICR loans, then the federal government might or might not reimburse lenders for the costs of ICR borrower subsidies (that is, for uncapitalized interest and for loan balances forgiven after 25 years). Under all market mechanism models, the federal government would pay the costs of the subsidies if it reimbursed lenders for the costs of these subsidies. However, a decision by the Congress not to require the federal government to reimburse lenders for the costs of the subsidies could mean, depending on the market mechanism model, that lenders, borrowers, or the federal government actually paid the costs of the subsidies.

Under adjustments to the current system, if the federal government reimbursed lenders for the costs of borrower subsidies, then federal FFELP costs would be higher than if lenders received no reimbursement. If the federal government did not reimburse lenders for the costs of borrower subsidies, then FFELP lenders would pay for the subsidies. However, lender participation in FFELP would probably be reduced, and loan availability might also be reduced.

Under the federal funding model, if lenders borrowed at a predetermined interest rate, then lenders' costs would be higher if the federal government did not reimburse them for borrower subsidy costs. Such a cost increase would be likely to reduce lender participation in FFELP, reduce any discounts currently available to borrowers, and possibly reduce loan availability.

Under all auction models, including the auction variant of federal funding, whether the federal government reimbursed lenders for the costs of borrower subsidies would not affect whether the federal government actually paid those costs. Lenders' bids would depend on whether the federal government reimbursed them for those costs. If it did not reimburse lenders, then lenders' bids would reflect the increase in expected costs attributable to ICR. If loans (in the loan sale model) or origination rights (in the origination rights auction or volume procurement model) were grouped, bids would be lower for groups in which borrowers were more likely to receive ICR subsidies. Alternatively, ICR loans or the right to issue ICR loans could be auctioned separately from other origination rights. Under all auction models, the government would bear the anticipated cost of ICR subsidies in the form of lower revenue from bidding lenders. The net result could be higher or lower federal costs associated with privately held ICR loans, depending on whether the private lenders operating expenses were higher or lower than those of federally operated ICR.

Under market-set rates, if the federal government did not reimburse lenders for the costs of borrower subsidies, then lenders would probably charge borrowers higher interest rates, which would reflect the expected costs attributable to ICR. Therefore, borrowers would be likely to bear the anticipated cost of ICR subsidies for privately held loans. The borrowers whom lenders believed most likely to use ICR would bear the greatest share of the costs of the ICR subsidies. Regulatory limits on the rates lenders could charge may reduce the availability of FFELP loans, especially to borrowers whom lenders thought most likely to use ICR.

APPENDIX I
MANDATE FROM THE 1998 AMENDMENTS TO HEA

This appendix reprints paragraphs (a) – (d) of Public Law, Number 105-244, Section 801, Study of Market Mechanisms in Federal Student Loan Programs

(a) Study Required.--The Comptroller General and the Secretary of Education shall convene a study group including the Secretary of the Treasury, the Director of the Office of Management and Budget, the Director of the Congressional Budget Office, representatives of entities making loans under part B of title IV of the Higher Education Act of 1965, representatives of other entities in the financial services community, representatives of other participants in the student loan programs, and such other individuals as the Comptroller General and the Secretary may designate. The Comptroller General and Secretary, in consultation with the study group, shall design and conduct a study to identify and evaluate means of establishing a market mechanism for the delivery of loans made pursuant to such title IV.

(b) Design of Study.--The study required under this section shall identify not fewer than 3 different market mechanisms for use in determining lender return on student loans while continuing to meet the other objectives of the programs under parts B and D of such title IV, including the provision of loans to all eligible students. Consideration may be given to the use of auctions and to the feasibility of incorporating income-contingent repayment options into the student loan system and requiring borrowers to repay through income tax withholding.

(c) Evaluation of Market Mechanisms.--The mechanisms identified under subsection (b) shall be evaluated in terms of the following areas:

(1) The cost or savings of loans to or for borrowers, including parent borrowers.

(2) The cost or savings of the mechanism to the Federal Government.

(3) The cost, effect, and distribution of Federal subsidies to or for participants in the program.

(4) The ability of the mechanism to accommodate the potential distribution of subsidies to students through an income contingent repayment option.

(5) The effect on the simplicity of the program, including the effect of the plan on the regulatory burden on students, schools, lenders, and other program participants.

(6) The effect on investment in human capital and resources, loan servicing capability, and the quality of service to the borrower.

(7) The effect on the diversity of lenders, including community-based lenders, originating and secondary market lenders.

(8) The effect on program integrity.

(9) The degree to which the mechanism will provide market incentives to encourage continuous improvement in the delivery and servicing of loans.

(10) The availability of loans to students by region, income level, and by categories of institutions.

(11) The proposed Federal and State role in the operation of the mechanism.

(12) A description of how the mechanism will be administered and operated.

(13) Transition procedures, including the effect on loan availability during a transition period.

(14) Any other areas the study group may include.

(d) Preliminary Findings and Publication of Study.--Not later than November 15, 2000, the study group shall make the group's preliminary findings, including any additional or dissenting views, available to the public with a 60-day request for public comment. The study group shall review these comments and the Comptroller General and the Secretary shall transmit a final report, including any additional or dissenting views, to the Committee on Education and the Workforce of the House of Representatives, the Committee on Labor and Human Resources of the Senate, and the Committees on the Budget of the House of Representatives and the Senate not later than May 15, 2001.

APPENDIX II
LIST OF STUDY GROUP MEMBERS

APPOINTED BY EDUCATION AND GAO:

Corye Barbour
Legislative Director
United States Student Association

Bill Beckmann
President and Chief Executive Officer
Student Loan Corporation

Mary F. Bushman
Vice President, Government Relations
AFSA Data Corporation

Kathy Cannon
Senior Vice President
Bank of America

Judy Case
Director of Financial Aid
University of Massachusetts Medical School

Rene R. Champagne
Chairman, President and Chief Executive Officer
ITT Educational Services, Inc.

Jacqueline Daughtry-Miller
Vice President, Student Loan Department
Independence Federal Savings Bank

Anthony P. Dolanski
Director, Sallie Mae Servicing
Sallie Mae, Inc.

Ivan Frishberg
Higher Education Project Director
U.S. Public Interest Research Group

Richard D. George
President and Chief Executive Officer
Great Lakes Higher Education Corporation

Jonathan Gruber
Department of Economics
Massachusetts Institute of Technology

Michael H. Hershock
President and Chief Executive Officer
Pennsylvania Higher Education Assistance Agency

D. Bruce Johnstone
Department of Higher and Comparative Education
University at Buffalo

James C. Lintzenich
President and Chief Executive Officer
USA Group

Claire J. Mezzanotte
Senior Director, Structured Finance, Asset Backed Securities
Fitch IBCA, Inc.

David Mohning
Director of Student Financial Aid
Vanderbilt University

Deborah Mott
Senior Vice President, Corporate Finance
Ferris, Baker Watts, Incorporated

Barmak Nassirian
American Association of Collegiate Registrars and Admissions Officers

Chalmers Gail Norris
Executive Director
Utah Higher Education Assistance Authority

Richard H. Pierce
President and Chief Executive Officer
Maine Education Services

Susan L. Pugh
Director, Office of Student Financial Assistance
Indiana University Bloomington

Marilyn B. Quinn
Executive Director
Delaware Higher Education Commission

Robert A. Scott
President
Adelphi University

Patricia Smith
American Association of State Colleges and Universities

Paul S. Tone
Senior Vice President, Industry and Government Relations
UNIPAC

Laurie Wolf
Director, Enrollment Management
Des Moines Area Community College

Paul W. Wozniak
Managing Director
PaineWebber Incorporated

DESIGNATED BY FEDERAL AGENCIES:

Nabeel Alsalam
Principal Analyst
Congressional Budget Office

Barbara Bovbjerg
Associate Director, Education, Workforce, and Income Security Issues
U.S. General Accounting Office

Robert Cumby
Deputy Assistant Secretary, Office of Economic Policy
U.S. Department of the Treasury

Maureen McLaughlin
Deputy Assistant Secretary, Office of Postsecondary Education
U.S. Department of Education

Lorenzo Rasetti
Program Examiner
Office of Management and Budget

APPENDIX III
TECHNICAL ASPECTS OF AUCTION DESIGN

Several of the policy options reviewed in this report, particularly those that are reviewed in chapters 3 and 4, involve some sort of auction mechanism for setting the terms on which student loans are originated. The purpose of this appendix is to review the relevant theoretical and empirical literature on auctions.

IDEAL CONDITIONS FOR AUCTIONS TO WORK

Standard theoretical treatments of auctions in the economic literature generally assume that the objective of the party conducting the auction is pecuniary; that is, that a successful auction is one that provides the most favorable price quotations by bidders.[39] Bidders are likely to make more attractive bids, other things being equal, when the following conditions are present: a large number of bidders, easy entry and exit conditions for bidders, as much relevant information as possible available to bidders, and the existence of secondary markets. However, in many practical situations, the state of the market deviates from the ideal conditions described above. For example, as we noted in chapter 1, the student loan market has been characterized by the concentration of much of the business in the hands of a few large lenders.

The competitiveness of a market can affect the success of auctions, but auctions themselves can influence the competitiveness of the market. In the short term, auctions either may make the market more competitive or may have no effect on competition. They may increase competition by enabling new participants to enter the market on relatively equal terms with existing participants. Alternatively, auctions may have no effect on competition if entry into the market is so expensive that no new participants are willing to enter. In the long term, it is possible that auctions will gradually reduce competition and, in the case of FFELP, increase federal costs, although how likely this outcome is cannot be known.

The current student loan market, however, may not be competitive enough to enable auctions to produce savings for the federal government. This may be because a few large lenders dominate the student loan market and it is costly for new lenders to enter the market. The dominant lenders' influence on the winning bids could conceivably lead to FFELP costs that are as high as or higher than current costs. Lenders might also collude in setting their bids. The relatively small number of lenders in the market would make collusion easier.

The student loan program is distinguished by several nonpecuniary policy objectives, such as encouraging participation by small lenders, maximizing access by student borrowers, and maximizing families' choices of postsecondary education options.

[39] As we noted in chapter 3, in the context of the student loan program, this could be defined in one of several ways: the interest rate offered by bidders, a markup over a reference rate such as a T-bill rate or the commercial paper rate, or a price to be offered by bidders. Unless otherwise noted, the discussion in this appendix pertains to any pecuniary outcome.

OPTIONS FOR AUCTION DESIGN

There are various ways of structuring the auction process. We review several of the variants that have been used in financial markets, or that have been proposed for the student loan program. Where appropriate, we note aspects of auction design that might be significant when the auction is being conducted under less than ideal conditions. Although most of the available theory and evidence pertains to the implications of auction designs for pecuniary outcomes, we also note the implications of auction design for nonpecuniary policy objectives. This list is by no means exhaustive. Although we indicate whether a particular auction design may be more or less conducive to attaining certain objectives than another auction design, we do not generally answer the question of whether auctions as such are superior to non auction methods of setting interest rates and other terms for student loans.

Uniform Versus Multiple Prices

In an auction for multiple identical items, where bidders can bid on different quantities of the item, competitive bids state the amount and price desired and are ranked from the highest to the lowest price. Bids are accepted at successively lower prices until the desired level of funds has been raised or all items are sold. In a uniform-price auction, all winning bidders then pay the same price—the cut-off price.[40] By contrast, in a multiple-price auction, all accepted bids are filled at the price that each bidder bid, so some wining bidders pay more than others.

Treasury recently made a transition from multiple-price auctions to single-price auctions in its auctions of Treasury securities. A Treasury official told us that the uniform-price auction was expected to produce benefits, from Treasury's point of view, in that it would encourage more bidders to participate in bidding by reducing the importance of specialized knowledge regarding market demand and the information costs associated with its collection. It expected that the concentration of bidders would decline and that there would be more revenue to the Treasury. Its analysis of data from the initial experience with single-price auctions lends modest support for these predictions.

Single Versus Multiple-Round Auctions

Rather than selling items one at a time, a large set of related items can be auctioned simultaneously, with the auctioning continuing for multiple rounds until the best possible price is attained for all items. FCC uses multiple-round auctions for some of it auctions of licenses. The auction closes when all bidding activity has stopped on all licenses. The principal advantage of a multiple-round auction is the information that it provides bidders about the value other bidders place on a license. This information increases the likelihood that licenses will be assigned to the bidders that value them the most and will generally yield more revenue than auctions where there

[40] A variant of this technique involves accepting the second highest bid.

is much uncertainty about common factors that affect the value of a license to all bidders - that is, who bid and how much was bid. In a multiple-round auction, bidders need not guess about the value the second highest bidder places on the license because bidders have the opportunity to raise their bids if they are willing to pay more than the current high bidder

Multiple-round bidding is also more likely than single-round bidding to be perceived by participants and observers as open and fair. Auction theory shows that multiple-round bidding tends to increase revenue by reducing the incentive for bidders to be overly cautious during bidding while trying to avoid the winner's curse—meaning the highest bidder would bid too much and regret its purchase. Multiple-round bidding provides information about other bidders' estimates of common information, thus reducing bidders' incentive to bid cautiously so as to avoid falling victim to the winner's curse and regretting their purchases.

An auction that has a single round of bidding is faster than one with multiple rounds, and the bid evaluation process is simpler. Also, a multiple-round auction may be more vulnerable to collusion than a single-round auction and an auction in which each bidder pays a different price could be either more or less susceptible to collusion than one in which all bidders paid the same price.

Sealed Bid Versus Open Outcry Auctions

In a sealed-bid auction, each bidder submits a single bid. The bids are then all opened at once and the winner is determined. By contrast, in an open-outcry auction, bidders submit bids publicly and then have the opportunity to revise their bids in light of other bids. Open-outcry auctions are generally not used in financial markets. A Treasury official told us that for Treasury auction, it was important to minimize event risk – that is, the risk that market conditions will change while the auction is ongoing. An open-outcry auction for Treasury securities might increase this risk.

Auction Frequency

In a potential auction in FFELP, whether for loan origination rights or for loans that have already been originated, how frequently auctions would be held would be an important decision. FFELP costs could be higher the more frequently auctions were held. Because there would be some costs to conducting each auction, the total administrative costs of auctions would be higher the more frequently auctions were held. Similarly, the cost to lenders of bidding in auctions would be higher the more frequently auctions were held, which could reduce the number of bidders. More frequent auctions could also result in fewer bidders because some lenders would not find it worthwhile to enter the FFELP market if they could not be sure of remaining in it for a long time. With less competition among lenders, federal payments to lenders could be higher.

However, there are also reasons why FFELP costs could be lower with more frequent auctions. Because lower-cost lenders can outbid those with higher costs, lenders would have a greater incentive to reduce their costs the more frequently auctions were held. Therefore, federal

payments to lenders could be lower with more frequent auctions. In addition, lenders might increase their profits during the time between auctions if they were able to reduce their costs during that time. The federal government would capture more of these profit increases and could therefore make lower payments to lenders the more frequently auctions were held. Furthermore, more frequent auctions reduce lenders' risk that the interest payments they would receive would be out of line with their cost of funds. Therefore, more frequent auctions could make origination rights more valuable to lenders, reducing federal payments to them. Finally, more frequent auctions could make it more difficult for a few lenders to become entrenched as perennial auction winners. Thus, auction winners could face more competition at each auction. This competition could lead to lower federal payments to lenders.

Lender participation could be either higher or lower the more frequently auctions were held. Because the cost to lenders of bidding in auctions would be higher the more frequently auctions were held, more frequent auctions could mean fewer bidders. Small lenders might be especially sensitive to the costs of bidding. However, because more frequent auctions reduce lenders' risk that the interest payments they would receive would be out of line with their cost of funds, they could make origination rights more valuable to lenders, inducing more lenders to participate. Also, more frequent auctions could make it more difficult for a few lenders to become entrenched as perennial auction winners. Thus, past auction winners could face more competition at each subsequent auction.

Frequent auctions could impose substantial burdens on lenders, students, and schools. Because participating in auctions would cost lenders both money and time, more frequent auctions would be more burdensome to lenders. Because both students and schools value the ability to deal with a single lender, more frequent auctions could impose a greater burden on them by disrupting long-term student-lender and school-lender relationships. Less frequent auctions could have a negative impact on service quality. Lenders whose rights to originate loans were secure for many years might pay less attention to service. If this occurred, then students might become confused about their repayment responsibilities and the default rate might rise. However, less frequent auctions could also improve service. Students value the ability to borrow from a single lender. Having this ability may make it easier for them to keep track of and repay their debts, thereby reducing the default rate. The more frequently auctions were held, the more likely it would be that a student would have to change lenders, especially if each auction had only one winning lender per school. This effect of auction frequency on service quality could be eliminated in several ways, though. Each student could be allowed to remain with one lender throughout his or her educational program, even if a different lender subsequently won origination rights at his or her school, or students who had more than one lender could retain the right to consolidate all their loans. Less frequent auctions could also improve service quality by facilitating long-term relationships between lenders and schools. The more frequently auctions were held, the more likely it would be that a school would have to change lenders, especially if each auction had only one winning lender per school.

Grouping

It is possible that auctioning origination rights or loan volume for small groups of schools would produce higher federal FFELP costs than auctioning rights or volume for larger groups or conducting auctions without grouping schools. However, there is no information available to enable us to determine how likely this outcome would be. If the per-student cost of originating loans declines as the number of students served increases, then it is less expensive for each lender to serve a large number of students than to serve only a few students. Under these conditions, total lender costs are lower when there are a few lenders, each of which serves many students, than when there are many lenders, each of which serves a few students. Therefore, federal payments to lenders would be greater when each of a large number of auction winners served a small number of students than when each of a small number of winners served many students. If schools were bundled into small groups when auctions were held, then it is possible that the auctions would produce a large number of winning lenders, each of which would serve relatively few students. This outcome could be less likely if schools were bundled into large groups or if schools were not grouped at all. Thus, federal payments to lenders could be higher the larger the number of school groups. For example, federal payments to lenders could be greater if schools were grouped by state than if origination rights for all FFELP-eligible schools were auctioned as a single package.

Likewise, it is possible that FFELP costs would be higher if multiple lenders were permitted to serve each school than if there were only a single lender for each school. Once again, there is no information available to enable us to determine the likelihood of this outcome. As the previous paragraph showed, it is possible that federal payments to lenders would be greater if each of a large number of auction winners served a small number of students than if each of a small number of winners served many students. If many lenders were allowed to serve students at each school, then there could be a large number of winning lenders, each of which served relatively few students. This outcome could be less likely if only one lender were allowed per school. Federal payments to lenders could be greater with multiple lenders per school than with a single lender per school.

How schools were grouped together in the auctions would likely affect the distribution of federal payments to lenders. If schools were not grouped or if the characteristics of each group of schools resembled those of FFELP-eligible schools as a whole, then the distribution of those payments would probably be similar to what it is at present. However, if schools in each group were similar to one another but different from those in other groups, then lenders would bid more for the right to originate loans in the groups they perceived as more desirable (for example, those with higher per-student loan amounts and lower default rates) than for the right to originate in "less desirable" groups. Federal payments to lenders that won origination rights in the "less desirable" groups would then be greater than federal payments to lenders that won rights in the "more desirable" groups. The resulting pattern of unequal federal payments to lenders would give the federal government better information about the costs of lending to students at different schools, but in so doing it could also lead to an erosion of political support for FFELP. A similar pattern of unevenly distributed federal payments to lenders would likely result if lenders were allowed to define their own groups of schools when they bid. If lenders defined their own groups of schools, they would probably group schools according to such characteristics as per-student loan amounts and default rates.

Students in low-income regions, those from low-income families, and those attending proprietary vocational schools could lose access to loans if Education grouped similar schools together or allowed lenders to define their own groups of schools. In a volume procurement auction, those types of students could lose loan access if winning lenders were allowed to choose the students to whom they would lend. Lenders would be likely to consider those kinds of students as presenting especially high default risks. If they were allowed to do so, some lenders might refuse to lend to students with those characteristics or to bid on groups of schools that served such students. If similar schools were grouped together or if lenders were permitted to group schools themselves, then groups of schools that lenders perceived as serving students with high risks of default (for example, schools with very high student loan default rates) might attract no bids. In a volume procurement auction in which winning lenders were permitted to choose their borrowers, lenders might refuse to lend to students at those schools.

Ability to Pay

Auctions that involve payments to a government entity by a successful bidder for specified rights, as opposed to offering an interest rate, would require rules to ensure that bidders were able to pay the amounts they bid. Without such rules, non serious bidders could distort competition. Other federal auctions provide examples of rules that could be adopted in an origination rights auction. In its sulfur dioxide emission allowance auctions, EPA requires each bidder to send a certified check or letter of credit to cover its bid before the auction, or else to specify a method of electronic transfer or other payment method. (This rule is feasible only for sealed-bid auctions, in which each bidder submits a single bid.) FCC requires bidders in its wireless spectrum auctions to submit refundable deposits to cover the cost of placing bids. A final option, not used in any federal auction, is to require all potential bidders to show some evidence of their ability to pay. One way of implementing this option is to use FFELP eligibility criteria as evidence of ability to pay. Another alternative is to require FFELP-eligible lenders to pass additional ability-to-pay tests before allowing them to participate in the auction.

Federal costs could depend on whether winning bids are payable in full immediately after the close of the auction or whether a schedule of installment payments is allowed. Allowing installment payments enables small bidders to participate more easily. Small bidders would have to come up only with a down payment rather than with the full purchase price, enabling bidders with less funding to compete with better funded large bidders. However, allowing loan purchasers to pay in installments could result in winning bidders, not paying off the installments. When FCC allowed some spectrum auction winners to pay their bids in installments, it experienced many defaults by auction winners. This raised a related issue of who owns the auctioned item (student loans) if the purchaser declares bankruptcy. In the case of wireless spectrum rights auctioned by FCC, bankruptcy of winning bidders has left the disposition of the auctioned item to be determined by a bankruptcy court. Solving this issue with respect to student loan packages before implementation will enable Education to reclaim and resell such loans in subsequent auctions.

Small Bidders

Some federal auctions use several methods of ensuring small bidders' access. In its auctions of federal debt, Treasury allows small buyers not to participate in the auction and to agree in advance to buy a limited, pre specified amount of debt at the price that emerges from the auction. (Of course, only a small minority of buyers could use this option. If many buyers decided to use it, then the auctions would have few bidders and would not work properly.) Treasury also imposes a 35 percent limit on the market share of any winning bidder. FCC offers bidding credits to small bidders. In addition, FCC formerly allowed auction winners to pay their bids in installments, but this policy resulted in many defaults by auction winners. Independent of its annual auction, EPA gives electric power plants some sulfur dioxide emission allowances for free.[41] In the early years of its auctions, EPA also sold allowances at a fixed price outside auction. However, the price it set turned out to be much higher than the market price, and it later abandoned this practice.

Evidence from the FCC wireless spectrum auctions suggests that small-bidder protections can make auctions more competitive. In some early auctions, FCC gave preferential treatment to certain categories of bidders (such as women-owned and minority-owned businesses) for certain types of licenses. This policy intensified bidding competition among the non preferred bidders. At the same time, preferred bidders bid more for the licenses that were subject to the preferences than non preferred bidders would have been willing to pay for the same licenses. The preferences increased auction revenues.

Commercial Paper Versus Treasury Rates

FFELP costs could be lower if the maximum borrower interest rate were based on the commercial paper rate than if it were based on the 91-day T-bill rate. Under current law, the maximum borrower interest rate is based on the 91-day T-bill rate and the lender's cost of funds is based on the commercial paper rate. The relationship between the 91-day T-bill rate and lenders' cost of funds is relatively unstable. For this reason, federal payments to lenders that are based on the commercial paper rate are more valuable to lenders than federal payments that are based on the 91-day T-bill rate, for loans made at the same predetermined interest rate. A convenient way of setting a predetermined lender interest rate would be to set it equal to the

[41] In addition to protecting small lenders, free distribution of some student loan origination rights before auction could be a method of phasing in origination rights auctions.

borrower interest rate. Thus, if the borrower rate were based on the commercial paper rate, lenders' bids would be more favorable to the government than if the borrower rate continued to be based on the 91-day Treasury bill rate. FFELP costs would be lower if the basis for the borrower rate were changed to the commercial paper rate.

APPENDIX IV
DETAILS ON INCOME-CONTINGENT REPAYMENT IN FDLP

THE RATIONALE FOR INCOME-CONTINGENT REPAYMENT

ICR gives borrowers the opportunity to repay student loans based on their income. One analyst has stated that current economic conditions place a greater burden on borrowers than borrowers of previous eras did. Low inflation means that today's graduates and borrowers will pay back, in real terms, as much as 40 percent more than student loan borrowers who graduated in the 1970s and 1980s. Graduates of earlier eras benefited from paying back their loans in cheaper dollars. Current borrowers cannot depend on inflation to reduce their "real" debt burden. However, today's graduates may have higher inflation-adjusted post graduation incomes than graduates of the 1970s and 1980s. We are unable to determine whether today's graduates face higher debt burdens relative to their incomes than graduates of earlier eras. However, if today's graduates do face higher debt burdens than graduates of the 1970s and 1980s, and if it is believed that today's graduates should have the same debt burdens as graduates of those earlier decades, then a properly designed and administered ICR plan can be justified as one way to reduce the burden for today's graduates. ICR allows some borrowers with low incomes or high debt burdens to maintain a good credit rating by making lower monthly payments than they would have to make under a standard repayment schedule. It may be especially valuable for some borrowers who are in the early stages of their careers.

DATA ON INCOME-CONTINGENT REPAYMENT IN FDLP

The Student Loan Reform Act of 1993 expanded the range of loan repayment options available under the federal student loan programs. Of interest to the study group on market mechanisms in the student loan programs is the use of the various repayment plans available in FDLP, especially the use of the ICR plan. The use of the various repayment plans varies significantly by whether the loan was a consolidation loan. Thus, we are providing an analysis of overall ICR usage in the Direct Loan program as well as ICR usage among consolidation borrowers.

All Loans in Repayment

Nearly 2.7 million borrowers have loans in repayment under FDLP. These borrowers have loan amounts totaling nearly $34 billion.[42] Of the total loan amount, 31 percent is subsidized Stafford loans, 17 percent is unsubsidized Stafford loans, 11 percent is PLUS loans, and 41 percent is consolidation loans. See table 15.

1. Of the total amount in repayment,
   56 percent is being repaid through the standard repayment plan,

[42] All information is as of May 31, 2000.

20 percent is being repaid through the graduated repayment plan;
12 percent is being repaid through the extended repayment plan, and
2 percent is being repaid through ICR. Roughly half of the loans being repaid under the ICR option require payments that are less than the interest due on the loan. See table 15.

Consolidation Loans in Repayment

As shown in table 14, consolidations are more than 40 percent of the Direct Loan repayment portfolio by loan amount, and Education tracks this closely, as it allows borrowers to consolidate defaulted loan(s) for the purpose of obtaining an income contingent repayment arrangement. Defaulted loans that are not being rehabilitated through the Direct Loan income contingent repayment or another reasonable and affordable plan are normally pursued and collected by collection agencies contracted by Education's Debt Collection Service (DCS).

Nearly 710,000 borrowers have consolidation loans in repayment totaling more than $14 billion in original loan amounts. Almost all (95 percent) of the $14 billion in original loan amounts are "regular" consolidation loans. The remaining 5 percent represent loans previously held by DCS. See table 16.

Of the total consolidation amount in repayment (table 17)
29 percent is being repaid through the standard repayment plan,
27 percent is being repaid through the ICR plan. Roughly half of the loans being repaid under ICR require payments totaling less than the interest owed on the loan,
22 percent is being repaid through the graduated repayment plan, and
20 percent is being repaid through the extended repayment plan. See table 17.

Of the loans being repaid through income-contingent repayment (see the 193,289 borrowers in table 15). 94 percent are consolidation loans (see the 182,178 borrowers in table 17).

Of the consolidation loan amounts previously held by DCS, 11 percent are in ICR. Of the regular consolidation loan amounts, not previously held by DCS, 28 percent are in ICR. See tables 18 and 19.

Table 14: Direct Loan in Repayment by Loan Type

Loan	Number of borrowers	Percent of total borrowers	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Subsidized	1,501,329	56%	$9,627,369,029	$10,431,517,693	$6,948	31%
Unsubsidized	932,386	35	5,861,802,639	5,694,855,988	6,108	17
PLUS	372,453	14	3,335,602,873	3,788,560,419	10,172	11
Consolidation	709,786	26	13,447,855,619	14,070,935,315	19,824	41
Total[a]	**2,684,031**	**100%**	**$32,272,630,160**	**$33,985,869,415**	**$12,662**	**100%**

[a] Unduplicated borrower count.

Table 15: Direct Loans in Repayment by Plan

Repayment plan	Number of borrowers	Percent of total borrowers	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Standard	1,944,060	72%	$17,315,051,937	$18,884,768,619	$9,714	56%
Graduated	402,876	15	6,757,482,096	6,729,516,982	16,704	20
Extended	149,703	6	3,981,172,966	4,116,109,476	27,495	12
Income contingent repayment	193,289	7	4,041,457,111	4,049,233,342	20,949	12
Payments greater than or equal to interest	101,725	4	2,033,145,308	2,057,503,793	20,226	6
Payments less than interest	91,564	3	2,008,311,803	1,991,729,549	21,752	6
Alternative plan	10,740	0	177,466,051	206,240,996	19,203	1
Total[a]	**2,684,031**	**100%**	**$32,272,630,160**	**$33,985,869,415**	**$12,662**	**100%**

[a] Unduplicated borrower count.

Table 16: Source of Direct Consolidation Loans in Repayment

Consolidation type	Number of borrowers	Percent of total borrower count	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Regular consolidation loans	598,715	84%	$12,762,306,108	$13,362,649,377	$22,319	95%
Defaulted loans formerly held by DCS	112,135	16	684,081,869	706,738,859	6,303	5
Total[a]	**709,786**	**100%**	**$13,446,387,978**	**$14,069,388,236**	**$19,822**	**100%**

[a] Unduplicated borrower count.

Table 17: Direct Consolidation Loans in Repayment by Plan

Repayment plan	Number of borrowers	Percent of total borrower count	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Standard	301,817	43%	$3,729,080,437	$4,145,517,660	$13,735	29%
Income contingent repayment	182,178	26	3,816,246,780	3,834,087,757	21,046	27
Payments less than interest	87,383	12	1,923,399,764	1,936,038,142	22,156	14
Payments greater than or equal to interest	94,795	13	1,892,847,016	1,898,049,615	20,023	13
Graduated	137,190	19	3,053,074,468	3,101,952,324	22,611	22
Extended	84,028	12	2,730,481,991	2,852,202,918	33,943	20
Alternative plan	5,337	1	117,197,409	135,216,042	25,336	1
Total[a]	**709,786**	**100%**	**$13,446,081,085**	**$14,068,976,702**	**$19,821**	**100%**

[a] Unduplicated borrower count.

Table 18: Direct Consolidation Loans in Repayment by Plan: Defaulted Loans Formerly Held by DCS

Repayment plan	Number of borrowers	Percent of total borrowers	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Standard	63,550	57%	$318,715,398	$343,082,099	$5,399	49%
Graduated	29,748	27	216,876,576	216,141,878	7,266	31
Income contingent repayment	11,778	11	80,719,328	77,778,778	6,604	11
Extended	6,905	6	66,899,517	68,730,851	9,954	10
Alternative plan	10	0	40,742	45,933	4,593	0
Total[a]	**112,135**	**100%**	**$683,251,561**	**$705,779,539**	**$6,294**	**100%**

[a] Unduplicated borrower count.

Table 19: Direct Consolidation Loans in Repayment by Plan:
Regular Consolidation of Non-DCS Loans

Repayment plan	Number of borrowers	Percent of total borrowers	Principal balance outstanding	Loan amount	Average loan amount	Percent of total loan amount
Standard	238,397	40%	$3,409,473,808	$3,801,485,419	$15,946	29%
Graduated	77,204	13	2,663,424,434	2,783,316,598	36,051	21
Income contingent repayment	107,603	18	2,835,914,828	2,885,506,253	26,816	22
Extended	170,798	29	3,735,395,565	3,756,175,778	21,992	28
Alternative plan	3,523	1	89,756,731	103,761,954	29,453	1
Total[a]	**598,715**	**100%**	**$12,733,965,367**	**$13,330,246,002**	**$2,265**	**100%**

[a] Unduplicated borrower count.

ICR Usage Under FDLP

Although the ICR option appears to be more expensive for many borrowers over the full repayment term than, for example, the standard repayment plan, no ICR borrower "overpays" interest (unless the plan has been established with an internal cross-subsidy). Analyses of possible repayment options, as well as contemporary repayment calculators that are provided to aid borrowers' choices among various repayment plans, are typically described in total dollars rather than in terms of the net present value of those dollars. This can make ICR seem to be more expensive for borrowers than it really is. Some observers believe that this illusory high-interest cost of ICR has discouraged financial aid administrators from urging borrowers to consider choosing it. Also, these analyses and repayment calculators at best can only assume, and not predict, a borrower's future income. Such projections have typically specified the historical income growth for college graduates (on average, 5 percent annually). However, ICR is more valuable to borrowers with a flatter income trajectory. The fact that ICR usage has not approached initial projections does not mean that the ICR option should be discarded. While the currently operational ICR plan may in fact be relatively unattractive to many borrowers, financial aid administrators' poor familiarity with the plan has certainly affected the plan's take-up rate.

MONTHLY PAYMENT CALCULATION FOR LOANS IN ICR

The monthly payment calculation under ICR is the lesser of

- principal balance and adjusted gross income (AGI) based calculation or
- 20 percent of the borrower's discretionary income. These two calculations are explained below.[43]

[43] See also "Examples of the Calculations of Monthly Repayment Amounts," published annually in the Federal Register, most recently at 65 Fed. Reg. 34,006 (25 May 2000).

Principal Balance and AGI-Based Calculation

The monthly payment is the amount the borrower would repay annually over 12 years, using standard amortization multiplied by an income percentage factor based on the borrower's or couple's AGI and whether the borrower is single or married and head of the household.

$$12 \text{ year standard amortization} = \frac{(\text{principal balance})(\text{monthly interest rate})}{[1 - (\text{monthly interest rate} + 1)^{-n}]}.$$

The monthly interest rate is equal to the annual interest rate divided by 12, and n is the number of months remaining in the repayment term.

For this calculation, the principal balance is the original principal balance plus any capitalized interest when the borrower first entered repayment. This amount remains static except for the following situations:

1. *Reporting new disbursements, disbursement adjustments, and cancellations*. The principal balance is adjusted to reflect these changes.
2. *A new loan is received after the new loan has entered repayment*. In this situation, the principal balance is the principal balance of the new loan when the loan first entered repayment plus any capitalized interest when the borrower first enters repayment plus the outstanding principal balance on the existing loans (including capitalized interest) plus outstanding accrued interest, collection charges, late charges, and any other charges.
3. *Borrowers request joint repayment*. In this situation, the principal balance is recalculated on the basis of the borrower's combined outstanding principal balance when the borrower enters joint repayment plus any capitalized interest at the time the borrower first enters repayment plus the outstanding principal balance on the existing loans (including capitalized interest) plus outstanding accrued interest, collection charges, late charges, and any other charges.
4. *For purpose of the annual recalculation of the payment amount when new income information is received, after periods in which a borrower makes payments that are less than interest accrued on the loan.* In this situation, the principal balance is the highest outstanding principal balance (including amounts capitalized) calculated for the borrower while paying under the ICR Plan if this amount is higher than the original principal balance when the loan first entered repayment, plus any capitalized interest.

The monthly payment calculation is principal based and AGI based monthly payment = (12-year standard amortization * income percentage factor).

The income percentage factor is obtained from a table published annually by the Secretary in the Federal Register[44]. If the borrower's exact AGI is not found in the table, the income percentage factor is obtained by linear interpolation between the next higher and next lower AGIs. The linear interpolation method calculates the income percentage factor on the basis of intervals between the incomes and income percentage factors on the table.

[44] 65 Fed. Reg. 34, 007 (25 May 2000).

20 Percent of the Borrower's Discretionary Income

The borrower's discretionary income is calculated on the basis of poverty guidelines provided by the U.S. Department of Health and Human Services (HHS):

discretionary income = AGI - poverty guideline

Thus, the monthly payment calculation is discretionary income monthly payment = (discretionary income * 0.20)/12.

Treatment of Married Borrowers Not in Joint Repayment

For a married borrower to be eligible for ICR, the borrower's income information and the borrower's spouse's income information is required, even if the spouse files a separate income tax return. Thus, both spouses are required to sign the IRS consent form. In addition, both spouses are required to provide the same required income type, AGI, or alternative documentation of income. If both spouses have Direct Loans and are in joint repayment, the servicer refers to the borrower who has the most recent in-school period to determine income type.

If the borrower is separated from the borrower's spouse, the borrower is not required to provide the spouse's income. The borrower is required to send the servicer a self-certifying statement that indicates the change in marital status. If the borrower is separated from the borrower's spouse and the borrower filed a joint income tax return, the borrower may submit alternative documentation of income for only the borrower.

Treatment of Married Borrowers in Joint Repayment

Married borrowers may choose to repay their loans jointly under ICR. The decision to repay jointly under ICR does not make the borrowers liable for each other's Direct Loan debt. Joint repayment is used as a method to determine the borrowers' monthly repayment amounts. In order to be eligible, both borrowers are required to request joint repayment on the Repayment Plan Selection Form. The payment amount is based on the borrowers' combined outstanding Direct Loan debt and the borrowers' combined income when the servicer calculates the borrowers' joint repayment amount. The borrowers' individual payment amount is determined so that each payment amount is proportionate to each person's level of Direct Loan debt. When applying payments in any joint repayment situation, payments should be applied to interest on both borrowers' accounts before payments are applied to principal on either account. This helps avoid negative amortization on either account. Obviously, if payments are not high enough to cover interest on both accounts, there will be negative amortization. In cases where both spouses choose joint repayment for their Direct Loans and the loans are serviced at different Servicers, one of the borrower's loans shall be transferred.

If the servicer holds the loans of only one borrower and the borrower is selecting ICR for the first time and wants to repay jointly, the Servicer should wait until the spouse's loans are transferred before calculating the joint repayment amount. Therefore, the borrower should be put on interest billing, even if the servicer has income information for borrower and spouse. The borrower should be left on interest billing until the spouse's loans are transferred.

Married borrowers may select joint repayment, even if their taxes were filed separately. The ICR plan does not assume that a borrower's AGI is proportionate to his or her debt. A joint payment amount is calculated on the basis of the combined AGI and combined debt amounts. The borrower receives a bill for the portion of the joint payment amount that is proportionate to the borrower's individual debt.

ALTERNATIVE DOCUMENTATION OF INCOME

The servicer is required to collect alternative documentation of income for the first year a borrower is in repayment and for certain borrowers for the second year.[45] All married borrowers must submit alternative documentation of income for their spouses, unless the borrower is separated from the borrower's spouse. If the borrower has been in repayment for more than a year, the servicer must determine whether the AGI data or alternative documentation of income should be used to calculate the ICR monthly repayment amounts.

The servicer collects alternative documentation of income from borrowers if the borrower's AGI from IRS would be likely to reflect any period of time in which the borrower was in an in-school period. If AGI data do not represent an in-school period, the servicer uses the AGI data from IRS to calculate the monthly payment amount. If the borrower receives an in-school deferment, the servicer does not consider the time spent in the in-school deferment as an in-school period. In situations in which the borrower has multiple loans with the servicer, if any of the loans require alternative documentation of income, the borrower is required to provide alternative documentation for all the loans.

If the borrower is not required to submit alternative documentation of income, the servicer calculates the borrower's monthly payment amount using the borrower's AGI data from IRS. However, the servicer collects alternative documentation of income in situations in which the IRS cannot provide the servicer with valid income information or if the borrower's reported AGI does not reasonably reflect the borrower's current income. The servicer accepts the borrower's alternative documentation for the following situations:

- special circumstances, such as loss of employment or change of employment or

[45] Documentation supporting the borrower's income can be in the form of a pay stub, a dividend statement, or a canceled check. If these types are not available, the borrower can provide a signed statement that explains the borrower's income sources and provides its address. If the borrower provides the servicer with other forms of supporting documentation, the servicer determines whether the documentation is acceptable at its own discretion, with guidance from Education's On-Site Monitor. Supporting documentation of alternative documentation of income cannot be older than 90 days.

- borrower did not file a sufficiently recent tax return, or
- IRS provided income information but not currently enough to determine the payment amount or
- IRS did not provide AGI data during the first AGI solicitation and the borrower did not request the servicer to re-solicit IRS.

In addition to these situations, the servicer can use alternative documentation of income from the borrower even when IRS is processing a request for AGI data or if AGI data are received from IRS. However, alternative documentation of income cannot be submitted or solicited solely to reduce the amount of time a borrower is assigned ICR interest-only monthly payments. The guideline is to be used only if the alternative documentation most accurately reflects the borrower's current ability to repay the loan. If the servicer has both current AGI and alternative documentation of income, the servicer uses the alternative documentation of income to calculate the monthly repayment amount, unless the borrower otherwise requests.

If a borrower and the borrower's spouse have chosen to repay their Direct Loans jointly, the servicer refers to the spouse who most recently left in-school status in order to determine whether AGI or alternative documentation of income should be solicited.

ANNUAL INCOME INFORMATION RENEWAL PROCESS

Each year, the servicer renews the borrower's income information, either by soliciting AGI data from IRS with the taxpayer's consent or by receiving updated alternative income information from the borrower. The servicer begins the annual income renewal process at the end of August each year. The servicer does not request updated income information if the servicer has received income information from the borrower within the past 6 months. For example, if the borrower entered repayment under ICR in March 1999, the servicer would not have renewed the borrower's annual income until August 2000.

If the borrower's loans require renewal of income information, the servicer is required to determine whether the borrower is required to submit alternative documentation of income or AGI data from IRS can be used. Valid AGI data cannot reflect an in-school period. If AGI data reflect an in school period, the servicer uses alternative documentation of income to recalculate the borrower's monthly payment amount.

Renewal for Borrowers Who Require AGI

At the end of August each year, the servicer attempts to solicit IRS for AGI data for the borrower and the borrower's spouse. If the servicer cannot obtain the AGI data, the servicer asks the borrower to submit alternative documentation of income. Alternative documentation of income is acceptable to recalculate the payment amount if the AGI data are not obtained from IRS or if the AGI data do not accurately reflect the borrower's current income. Once updated income

information is received, the servicer recalculates the borrower's monthly payment amount. After the recalculation, the servicer discloses the borrower's new monthly payment amount.

If the servicer does not receive updated income information from IRS, or the Alternative Documentation of Income Form and supporting documentation from the borrower by the end of the calendar year, the servicer removes the borrower from the ICR Plan. The servicer reverts the borrower's loan(s) to the Standard Repayment Plan, or to the borrower's previous repayment plan if the borrower switched to ICR from another repayment plan.

Renewal for Borrowers Who Require Alternative Documentation of Income

For borrowers required to submit alternative documentation of income, the servicer asks the borrower at the end of August each year to submit the Alternative Documentation of Income Form and supporting documentation for income renewal purposes. The servicer uses the AGI data from the IRS to verify the borrower's previous year's alternative documentation of income information.

If the servicer does not receive the Alternative Documentation of Income Form and supporting documentation from the borrower by the end of the calendar year, the servicer removes the borrower from the ICR Plan. The servicer reverts the borrower's loans to the Standard Repayment Plan or to the borrower's previous repayment plan if the borrower switched to the ICR Plan from another repayment plan.

IRS Consent Form

Before the servicer is able to solicit AGI data from IRS, the borrower and the borrower's spouse are required to provide the servicer with a valid and signed IRS Consent to Disclosure of Tax Information form. A married borrower is not eligible for ICR without an IRS consent form with both spouses' signatures and IRS validation of the IRS consent form. When the servicer receives the IRS consent form, the servicer ensures that the borrower and spouse have correctly completed the form. If the form is incomplete, the servicer either sends an imaged copy of the incomplete consent form with a new consent form or retrieves the original consent form and sends it to the borrower and spouse to complete. The borrower and spouse must either complete a new consent form in its entirety and submit it to the servicer or complete the original consent form and submit it to the servicer.

Once the servicer receives a completed IRS consent form, the servicer images the borrower's IRS consent form and passes the image to IRS within 3 business days. If the form is invalid, for example, if IRS receives the image of the form more than 60 days after the date when the borrower signed the form, IRS rejects it. If IRS rejects the form, the servicer requests the borrower to re submit an updated form.
When IRS initially validates the form, the form is valid for 5 tax years. The 5 tax years are defined on the IRS consent form. Any subsequent renewals of the forms are also valid for 5 tax years.

Solicitation for IRS Consent Form Renewals

IRS consent form renewals are solicited in December of the year following the last covered tax year indicated on the form. For example, at the end of December 2000, the servicer has to begin the renewal cycle for all IRS consent forms that expired after the 1999 tax year. If the servicer does not receive a new IRS consent form from the borrower, the servicer requests an IRS consent form at least two additional times before the end of June. If the borrower does not provide an updated form, the servicer does not solicit updated AGI data in August. The servicer removes the borrower from the ICR Plan the December following the initial renewal attempt if the borrower does not provide the servicer with an updated IRS consent form and if updated income information is not received.

If the borrower voluntarily revokes the IRS consent form, the servicer immediately removes the borrower from the ICR Plan. If the borrower does not choose a new repayment plan, the servicer notifies the borrower that the servicer placed the borrower on the Standard Repayment Plan.

Treatment of Married Borrowers

A married borrower is required to have his or her spouse's consent authorizing IRS to disclose tax information for the purpose of determining the borrower's AGI. The servicer requires both spouses to sign the IRS consent forms in order for a married borrower to participate in the ICR Plan. Both spouses must sign the IRS consent form, even if the couple filed a joint tax return. Both signatures are required for all married borrowers, unless the borrower is separated from the spouse.

Soliciting AGI Data From IRS

The servicer solicits IRS for AGI data once a month. The servicer solicits the AGI data from IRS for a particular borrower either when initial or renewal AGI data are required. Depending on the AGI data sent by IRS the following three situations could occur:

- IRS mismatch. IRS is unable to recognize the borrower's or spouse's Social Security Number or name as provided by the servicer.
- No AGI Data. The borrower or spouse did not file a tax return the previous year covered by the IRS consent form. Or IRS provides outdated (or invalid) AGI data, because sufficiently current data were not available.
- The servicer receives sufficiently current AGI data. IRS provides the borrower's or spouse's current AGI data.

If IRS cannot provide the servicer with AGI data because of a mismatch, no AGI data are available, or IRS sent outdated AGI data, the servicer only resolicits IRS for AGI data on the borrower's request. (The borrower is permitted to request that the servicer resolicit IRS for AGI data at any time.) If IRS cannot provide income information, the servicer requests alternative

documentation of income from the borrower. When the servicer receives valid AGI data from IRS, the servicer calculates the borrower's monthly payment amount on the basis of the AGI.

Eligible AGI Data and Alternative Documentation of Income for Borrowers Entering ICR

AGI data used to calculate the repayment amount must be current data. Prior or next-prior calendar year AGI data (or both, for a married borrower and the borrower's spouse) from IRS are acceptable if received before August 31 for borrowers entering ICR who are required to provide AGI data. For information received after August 31, the servicer accepts only prior-year AGI data from the IRS. For example, 1998 or 1999 AGI data are acceptable if the servicer received the information from IRS before August 31, 2000. If the servicer received the information after August 31, 2000, only 1999 AGI data were acceptable. If the borrower submits alternative documentation of income, the only requirement is that the supporting documentation not be older than 90 days. If married borrowers have income information from two different tax years, the servicer designates the most current tax year to the income data.

Substitution for AGI Data

The servicer can accept a signed tax return with accompanying required documentation, for example, W-2 forms, 1099 forms) from the borrower as proof of AGI data, if the servicer cannot obtain the data from IRS. A signed tax return from the borrower cannot be considered alternative documentation of income but may be used temporarily to calculate the borrower's monthly payment amount. If the servicer receives a signed tax return from a borrower, the servicer attempts to recollect AGI data from IRS, using the signed tax return as proof that valid AGI data exists for the borrower. If the servicer continues to not be able to obtain AGI data from IRS, the servicer collects alternative documentation of income from the borrower to recalculate the borrower's monthly pay+ment amount.

APPENDIX V
CALL OPTIONS: AN ALTERNATIVE MECHANISM FOR DETERMINING NET LENDER YIELDS THROUGH SECONDARY MARKET ACTIVITIES

Through the inclusion of a "call option" on all new FFELP loans, competitive forces in the market could help establish lender yield on loans and remove any "excess" lender profits. The call option would give the Federal government the right to "buy" the FFELP loan within a specified time period at a predetermined price ("exercise price") set by legislative formula. The exercise price would be set at time of loan origination and would include consideration for a lender's cost in making the loan.

Within the specified time period, the Government would auction the call option (right to buy the loan). FFELP lenders willing to pay the highest positive value to the Government for the option would receive the right to purchase the loan at the predetermined exercise price. The Government would receive bid price on the option. If lenders were unwilling to bid a positive value for the option, the Federal government could purchase the loan at the exercise price or the originator would keep the loan.

The call option model utilizes competitive secondary market forces to determine the value of a loan. In determining whether and how much to pay for the call option, buyers review the expected value of the loan (including special allowance payments, interest payments, etc…) relative to the exercise price. In instances where the expected value exceeds the exercise price, potential buyers would likely bid positive amounts for the option.

Assume solely for illustration that origination costs were one percent of the loan amount. Under this assumption, the exercise price would be 101 percent of the face value of the loan. This exercise price would just compensate the originator for expenses. If the estimated income from the loan for the time it would be held were worth more to the originator, or to other potential loan holders, than 101 percent of the face value, then the option would have a positive value. Sale of the option by the government would recoup those excess returns.

EFFECT ON PROGRAM STRUCTURE

Under this mechanism, most aspects of the current FFELP could remain unchanged: As is generally true of the other models discussed in the body of the report, the Federal government could provide special allowance payments if deemed desirable as an addition to the lenders' return from a maximum statutory student interest rate, and loans would remain guaranteed lenders. Lenders would originate and service loans, and schools and borrowers could continue to choose their loan originator. Additionally, loan originators could continue to compete for loan volume through decreased interest rates and fees to students.

EFFECT ON BORROWERS

Financial benefits to students would remain unchanged or might increase under this model. It is unlikely that benefits to borrowers would decrease, because concessions by lenders would be a way of getting additional business; they would not be required to bid in advance for the additional loans. The concession to borrowers would diminish the likelihood that they would have to bid for the option to retain the loan.

The model could permit differential concessions to student borrowers but would not require differential student rates to assure loan availability. Availability of loans to all borrowers could be assured in one of several ways: (1) the special allowance payments and interest rates to provide a return adequate to service the most-expensive-to-service loans, (2) the government could exercise the options on expensive to service loans and resell the loans at a loss, (3) this model could be supplemented (as suggested for other models discussed above) by a lender of last resort or administrative requirements on FFELP lenders.

In a completely private exchange market, all options would not be sold for the same price, even apart from discounts to students. Because some loans are cheaper to service than others, as discussed earlier in this report, it would be expected that options on these loans would sell at a higher price. Where the government is on one side of the transaction, it would be desirable to bundle options by loan characteristic in order to allow for price variations to parallel these cost variations. The same issues of design of option bundles would emerge as would arise in the rights auction model, discussed above. The possibility of private transactions and bundling of government sales could mean that, unlike the current system in which special allowance payments provide a one-size-fits-all gross return, this option model could produce more efficient incentives for provision of all types of loans, without necessitating excess net returns for cheap-to-service loans.

BUDGETARY EFFECT

While it is unclear whether the Government would realize any budgetary savings under this model, Federal costs are not expected to increase. Any potential excess lender profits that would occur after the exercise date of the options would either be provided to students in the form of discounts or would be recouped by the Federal Government in the option price.

EFFECT ON LENDERS

The model would likely decrease or maintain existing lender returns in the aggregate. It is unlikely that overall lender returns would increase. Rather, if bundling of options by loan characteristics could be done effectively, the model would foster an environment where income would more closely match the characteristics of the loan. Loans with higher servicing costs (lower estimated value) would demand lower call option prices.

The originator of a loan might have a slight advantage in bidding on the options, because he would not bear the burden of exercising the options and loading the loans on his own, different loan servicing system. Combined with existing arrangements through which lenders essentially extend a line of credit to students for their course of study at a particular school, this advantage would tend to keep a student's loans with a given servicer. This would be efficient for both the servicer and the student. The existing possibilities for loan consolidation also need not be disturbed in this model.

MODEL CONSIDERATIONS

One key component of this program would be the call option exercise price (i.e., the price at which the government would have the right to acquire the loans). It should be established near the cost to originate student loans. If the exercise price were too low, loan originators would not participate. On the other hand, if the exercise price were too high, there would not be bidders for the options. The government would be required either to let them expire (leaving loans with the originators, who might earn an excess return) or to exercise the option and resell the loans at a loss (albeit, probably a small loss unless the error on the exercise price was quite large

The costs related to loan origination are very similar among all student loans regardless of expected delinquency or whether the loans are low- or high-balance. Measuring the cost of origination would require obtaining information that is readily available about certain fixed and variable costs. The origination allowance built into the exercise price could be a fixed amount of dollars per loan plus a percentage of the borrower's principal balance. Because many originators of student loans are currently not the ultimate holders, contracts with secondary marketers could also provide a source of information on origination costs. In contrast, when the Congress (or its designee) is evaluating the net return associated with a given SAP, it must measure a wide range of lender costs: servicing costs over the likely ten year life of loans, the effects of differing loan balances, the likelihood of default costs, and the likelihood that loans will be prepaid or consolidate. It should be much easier to determine the market cost of originating student loans than to determine the market rate of return for loans over their life, taking these other costs into account. .

Another key design decisions involves determining the call option availability period (time when the option can be exercised). Lender uncertainty regarding the option could be considerably reduced if the option first became effective near the time that many student loans are now most frequently sold by originators. This might be just as the loan entered repayment. Alternatively, the effective period for the option might be set earlier, if it were thought that a substantial portion of any excess profits on loans were received early in the life of the loan. In either case, it would seem desirable for the option to have a fixed expiration date, without an excessively long window in which it could be exercised.

APPENDIX VI
ADDITIONAL AND DISSENTING VIEWS: RENE CHAMPAGNE

I am particularly concerned with any proposal that attempts to segregate federal student loans by type of student or by type of institution because of the inherent opportunity for discrimination provided under such formulas. Title IV programs have been created by Congress to insure equal access to postsecondary education for all students regardless of race, ethnic background, gender or income level assuming the student met certain eligibility standards applied uniformly to all students. The same holds true for institutions. Congress has made it very clear that they will not tolerate the segregation of institutions reflected but heir support of Historically Black Colleges, Career Colleges and Schools and Community Colleges as well as traditional four-year institutions. I fear segregation by student type and institution type as contained in certain proposals borders on "redlining" and therefore must be avoided. "Blended" portfolios must continue to be used in the future to insure that all students are properly afforded equal access to the institution of their choice.

APPENDIX VII
ADDITIONAL AND DISSENTING VIEWS: MICHAEL HERSHOCK AND RICHARD PIERCE

January 16, 2001

Dear Reader:

Attached is a paper entitled "Today's Competitive Loan System is Already Filled with Market Mechanisms", prepared in our capacity as Members of the Market Mechanisms Study Group. We were assisted in the preparation of the paper by Harrison Wadsworth of the Education Finance Council.

We have requested that this paper be appended to the report of the study group because we believe that the paper presents a viewpoint that is not thoroughly explored in the body of the study group report. It is our hope that this paper will assist readers in better understanding the market forces currently at work in the Federal Family Education Loan Program.

The presentation of this paper is not intended as a dissenting view, nor should its presence in the report's appendix be interpreted as representing any particular characterization of the study group report.

Michael H. Hershock
President and CEO
Pennsylvania Higher Education Assistance Agency

Richard H. Pierce
President and CEO
Maine Education Services

This paper can be downloaded from our website at: http://www.gao.gov/mmsl/efcproposal.pdf

Today's Competitive Loan System Is Already Filled With Market Mechanisms

A proposal prepared for the Study Group On
Market Mechanisms in Federal Student Loan Programs

Prepared by: Richard H. Pierce
President and CEO
Maine Education Services

Michael Hershock
President and CEO
Pennsylvania Higher Education Assistance Agency

Harrison Wadsworth
Deputy Executive Director
Education Finance Council

May 5, 2000

APPENDIX VIII
ADDITIONAL AND DISSENTING VIEWS: PAUL TONE AND RICHARD PIERCE

This paper can be downloaded from our website at: http://www.gao.gov/mmsl/auctionf.pdf

April 2000

Student Loan Auctions: Issues and Implications

A Briefing Paper
Submitted by USA Group

USA Group gratefully acknowledges the contributions of the following orgar
in the preparation of this paper:

Consumer Bankers Association
Education Finance Council
National Council of Higher Education Loan Programs
Pennsylvania Higher Education Assistance Agency
Sallie Mae

GLOSSARY

Basis Point
One hundredth of 1 percentage point, or 0.01 percent. Used to measure changes or differences between yields or interest rates.

Basis Risk
A lender's risk that the basis of the interest rate at which he or she borrows to finance a loan and the basis of the interest rate that he or she receives from the loan will not move in tandem.

Borrower
The person responsible for repaying a loan who has signed and agreed to the terms in the promissory note.

Budget Scoring
The process of estimating the budgetary effects of pending and enacted legislation and comparing them to limits set in the budget resolution or legislation. Scorekeeping tracks data such as budget authority, receipts, outlays, the surplus or deficit, and the public debt limit. For purposes of the congressional budget process, the budget committees and the Congressional Budget Office are responsible for scoring legislation in relation to the levels set by the Congress in budget resolutions and the Budget Enforcement Act.

Capitalization
The addition of unpaid interest to the principal of a loan. Capitalizing interest increases the principal amount of the loan and the borrower's total cost of the loan.

Collection Costs
The cost the government incurs when collecting a delinquent or defaulted loan. Collection costs are charged to the borrower.

Commercial Paper
Short-term, unsecured promissory notes, issued primarily by corporations, with maturities up to 270 days. Many companies use commercial paper to raise cash needed for current transactions, and many find it to be a lower-cost alternative to bank loans.

Consolidation
The combination of multiple loans into a single new loan to simplify loan repayment. Also known as refinancing.

Debt Burden
The ratio of a borrower's loan payments to the borrower's income.

Default
Defined in FFELP as the borrower's continuous delinquency or failure to make a payment for 270 days in the case of a loan repayable in monthly installments or 330 days in the case of a loan

repayable in less frequent installments. If the delinquency persists for 270 days, the holder will file a default claim with the guarantor. The guarantor will review the claim to assure that the account has been serviced (minimal due diligence followed) according to regulatory requirements. If the holder is able to prove that the account has been serviced properly, the guarantor will purchase the loan from its holder. The guarantor, in turn, will request reimbursement through its reinsurance agreement with the Secretary.

Deferment
A deferment is a period during which borrowers do not need to pay principal and, for subsidized Stafford loans, the federal government pays interest. Borrowers are eligible for a deferment under certain conditions, such unemployment or going on to further postsecondary education.

Dependent Student
A student who does not meet the criteria for being classified as independent. See Independent Student.

Due Diligence
Compliance standards prescribed by federal regulations that govern loan making, disbursement, and servicing in the FFEL program. For example, due diligence in loan collection servicing requires that in the event of a delinquent loan, a lender shall engage in at least the collection efforts described in federal regulations.

Event Risk
The risk that market conditions will change while an auction is ongoing.

Forbearance
Permitting the temporary cessation of payments, allowing an extension of time for making payments, or temporarily accepting smaller payments than were previously scheduled. A lender may grant forbearance of payments of principal and interest, according to conditions specified by federal regulations, for up to a year at a time if both the borrower or endorser and an authorized official of the lender agree to the forbearance in writing.

Government Sponsored Enterprise (GSE)
A financial institution, established by federal law but privately owned and directed, that operates in the private sector capital market.

Income Percentage Factor
A factor that corresponds to a borrower's adjusted gross income (AGI) as shown in the income percentage factor table in a notice published annually by the Secretary of Education in the Federal Register.

Income Threshold
An income level below which loan borrowers are not required to make any repayments.

Independent Student

Independent students are those who, by meeting certain regulatory criteria, are presumed to receive no financial support from their parents. A student is considered "independent" if the student is: at least 24 years old; a graduate or professional student; a veteran of the U.S. Armed Forces; married; or has dependents other than a spouse. A financial aid administrator may also classify a student as independent under special circumstance even if none of these criteria are met.

Interest
An expense of borrowing money that is calculated as a percentage of the amount borrowed.

Lender of Last Resort
A lender who lends to borrowers who are unable to obtain loans from other lenders.

Lender Yield
The face value of the lender's interest rate on a FFELP loan. Currently, this is set in legislation the CP rate plus 1.74 percentage points when the student is in school or during other nonrepayment periods and 2.34 percentage points when the student is in repayment.

Lender Spread
The difference between a lender's yield and its funding costs (costs related to capital acquisition and interest expenses).

Loan Volume
The dollar amount or number of loans committed. Loan volume may be reported in thousands or millions of dollars.

Margin
A market-based add-on to a market rate. A margin can be negative and it changes on the basis of market conditions and the creditworthiness of the borrower.

Market Mechanism
A process involving the interaction of buyers and sellers, in which prices or interest rates are established on the basis of the amounts of money buyers are willing to pay or sellers are willing to accept.

Markup
An amount to be added to a reference rate to determine the new derived rate.

Match Funding
Refers to lenders matching the basis of the interest rate at which they borrow to finance a loan with the basis of the interest rate that they receive from the loan. If they are able to do so, then changes in the interest rate affect their costs and revenues identically and do not affect their net profits. If their funding costs and their revenues are based on different interest rates and those rates do not move in tandem, then their net profits could fluctuate. Hedging reduces or eliminates these fluctuations.

Multiple-Price Auction
An auction in which all accepted bids are filled at the price that each bidder bid.

Multiple-Round Auction
An auction in which a set of related items is auctioned simultaneously, with the auctioning continuing for multiple rounds until the best possible price is obtained for all items.

Negative Amortization
A gradual increase in loan debt that occurs when the monthly payment is insufficient to cover the interest due, and the balance owed continues to increase because unpaid interest is capitalized.

Open-Outcry Auction
An auction in which bidders submit bids publicly and then have the opportunity to revise their bids in light of other bids.

Operating Expenses
An expense incurred by a guaranty agency, such as salary and costs for travel, computer hardware and software, equipment, rent, and supplies and contractor costs.

Origination Fee
A fee charged and deducted from the proceeds of an FFEL program loan before the loan is disbursed. The origination fee offsets some of the administrative costs of loan processing. The fee must not exceed the maximum rate established by law. This fee is deducted from the interest and special allowance the federal government pays the lender. Generally, lending institutions pass this fee on to borrowers when the loans are made.

Present Value
The value today of a stream of payments in the future, discounted at the prevailing interest rate. According to the regulations of the Federal Credit Reform Act of 1990, the cost of a direct loan to the government is the net present value (when the direct loan is disbursed from the financing amount) of estimated cash flows – that is, loan disbursements, repayment of principle, interest repayment. For loans made, guaranteed, or modified, in fiscal year 2001 and thereafter, the cash flow estimated for each year (or other time period) is discounted by using the interest rate on a marketable zero-coupon Treasury security with the same maturity from the date of disbursement as that cash flow.

Principal Balance
The amount owed on a loan or loans at any given time. The principal balance may include capitalized interest.

Promissory Note
A legally binding contract between a lender and a borrower. The promissory note contains the terms and conditions of the loan, including how and when the loan must be repaid.

Proprietary Institution
A postsecondary institution that is operated for profit.

Reference Rate
An interest rate on a cash market instrument used, or referred to, in a formula for calculating another rate.

Repayment Period
The period during which a borrower is responsible for repaying his or her loan. In the case of Stafford loans, this period begins on the day after the last day of the grace period. In the case of PLUS and SLS loans, this period begins on the day the loan is fully disbursed. The maximum standard repayment period is 10 years, not including any authorized deferment or forbearance periods.

Risk
Lenders' risks in FFELP include

- Interest rate risk or basis risk. The risk that changes in interest rate levels and the spreads among different interest rates increase the volatility of returns, reduce returns, or even create or losses,[46]
- Political or regulatory risk. The risk that the program might be affected by unexpected legislative or regulatory changes,
- Credit risk. The risk of loss from borrower delinquencies (late payments) or defaults, which is almost but not completely ameliorated by guaranty agencies and the federal reinsurance guarantee;
- servicing risk -- the risk of mistakes and errors that may occur when servicing the loan can create credit risk for the lender because improper servicing can void the federal guarantee on student loans.

Sealed-Bid Auction
An auction in which each bidder submits a single bid and then all bids are opened at once.

Secondary Market
Financial institutions that purchase student loans from lenders and provide liquidity to the student loan market.

Securitization
The process of selling debt securities to investors with groups of loans serving as collateral for the debt.

Single-Price Auction
See Uniform-Price Auction.

[46] Basis risk is a form of interest rate risk in which the interest income and interest expenses are based on different instruments. Hedging minimizes this risk.

Single-Round Auction
An auction in which an item or a set of items is auctioned off with one single-round of bidding, as opposed to a multiple-round auction.

Special Allowance Payment (SAP)
A quarterly payment made by the government to FFELP lenders when lender yield exceeds the maximum borrower rate.

Uniform-Price Auction
An auction in which all successful bidders pay the same price, even if they submitted bids at different prices.

United States Treasury bill (T-bill)
A negotiable debt obligation issued by the U.S. government and backed by its full faith and credit. 91-day T-bills are the shortest term, regularly offered Treasury debt securities.